

Mattersight Corp  
Form 10-Q  
November 07, 2013  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**  
**Washington, D.C. 20549**

**Form 10-Q**

(Mark One)

**QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**  
**FOR THE QUARTERLY PERIOD ENDED SEPTEMBER 30, 2013**

**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 0-27975**

**Mattersight Corporation**  
**(Exact Name of Registrant as Specified in Its Charter)**

**Delaware**  
**(State or Other Jurisdiction of**  
**Incorporation or Organization)**

**36-4304577**  
**(I.R.S. Employer**  
**Identification No.)**

**200 S. Wacker Drive**

**Suite 820**

**Chicago, Illinois 60606**

**(Address of Registrant's Principal Executive Offices) (Zip Code)**

**(877) 235-6925**

**(Registrant's Telephone Number, Including Area Code)**

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or Section 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No

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

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

Large accelerated filer  Accelerated filer

Non-accelerated filer  (Do not check if a smaller reporting company) Smaller reporting company

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

The number of shares of the registrant's Common Stock outstanding as of October 30, 2013 was 17,362,740.



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**Table of Contents****Part I. Financial Information****Item 1. Financial Statements****MATTERSIGHT CORPORATION****CONDENSED CONSOLIDATED BALANCE SHEETS****(Unaudited and in thousands, except share and per share data)**

	<b>September 30, 2013</b>	<b>December 31, 2012</b>
<b>ASSETS:</b>		
Current Assets:		
Cash and cash equivalents	\$ 13,740	\$ 14,419
Receivables (net of allowances of \$14 and \$12)	2,209	2,568
Prepaid expenses	4,000	4,359
Other current assets	380	305
<b>Total current assets</b>	<b>20,329</b>	<b>21,651</b>
Equipment and leasehold improvements, net	5,487	4,727
Goodwill	972	972
Intangibles, net	257	236
Other long-term assets	4,627	3,776
<b>Total assets</b>	<b>\$ 31,672</b>	<b>\$ 31,362</b>
<b>LIABILITIES AND STOCKHOLDERS (DEFICIT) EQUITY:</b>		
Current Liabilities:		
Short-term debt	\$ 3,696	\$ 3,703
Accounts payable	732	781
Accrued compensation and related costs	1,218	1,335
Unearned revenue	10,830	5,853
Other current liabilities	3,876	2,889
<b>Total current liabilities</b>	<b>20,352</b>	<b>14,561</b>
Long-term unearned revenue	1,466	2,374
Other long-term liabilities	1,861	1,231
<b>Total liabilities</b>	<b>23,679</b>	<b>18,166</b>
Series B Stock, \$0.01 par value; 5,000,000 shares authorized and designated; 1,649,122 and 1,649,201 shares issued and outstanding at September 30, 2013 and December 31, 2012, respectively, with a liquidation preference of \$9,146 and \$8,705 at September 30, 2013 and December 31, 2012, respectively	8,411	8,411

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Stockholders' Equity:		
Preferred Stock, \$0.01 par value; 35,000,000 shares authorized; none issued and outstanding		
Common Stock, \$0.01 par value; 50,000,000 shares authorized; 18,919,276 and 18,407,848 shares issued at September 30, 2013 and December 31, 2012, respectively; and 17,362,740 and 17,114,880 outstanding at September 30, 2013 and December 31, 2012, respectively	189	184
Additional paid-in capital	222,035	216,667
Accumulated deficit	(210,629)	(201,000)
Treasury stock, at cost, 1,556,536 and 1,292,968 shares at September 30, 2013 and December 31, 2012, respectively	(7,974)	(7,027)
Accumulated other comprehensive loss	(4,039)	(4,039)
Total stockholders' (deficit) equity	(418)	4,785
Total liabilities and stockholders' (deficit) equity	\$ 31,672	\$ 31,362

See accompanying notes to the Condensed Consolidated Financial Statements.

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**MATTERSIGHT CORPORATION**  
**CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS**

(Unaudited and in thousands, except per share data)

	For the Three Months Ended		For the Nine Months Ended	
	September 30, 2013	September 29, 2012	September 30, 2013	September 29, 2012
Revenue:				
Behavioral Analytics revenue	\$ 8,307	\$ 7,682	\$ 24,067	\$ 23,795
Other revenue	302	308	973	1,029
Total services revenue	8,609	7,990	25,040	24,824
Reimbursed expenses	56	114	187	314
Total revenue	8,665	8,104	25,227	25,138
Operating expenses:				
Cost of Behavioral Analytics revenue	2,721	2,828	7,958	8,963
Cost of other revenue	163	155	517	546
Cost of services	2,884	2,983	8,475	9,509
Reimbursed expenses	56	114	187	314
Total cost of revenue, exclusive of depreciation and amortization shown below:	2,940	3,097	8,662	9,823
Sales, marketing and development	4,878	5,940	16,502	16,571
General and administrative	2,241	1,951	6,625	5,914
Severance and related costs	154	154	154	693
Depreciation and amortization	950	946	2,829	2,568
Total operating expenses	11,163	11,934	34,772	35,569
Operating loss	(2,498)	(3,830)	(9,545)	(10,431)
Interest and other expense, net	(125)	(88)	(313)	(303)
Loss from continuing operations before income taxes	(2,623)	(3,918)	(9,858)	(10,734)
Income tax (provision) benefit	(10)	(9)	229	(30)
Loss from continuing operations	(2,633)	(3,927)	(9,629)	(10,764)
Income from discontinued operations, net of tax		332		228
Net loss	(2,633)	(3,595)	(9,629)	(10,536)
Series B Stock fair value over stated value				(69)

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Dividends related to Series B Stock	(147)	(147)	(441)	(444)
Net loss available to Common Stock holders	\$ (2,780)	\$ (3,742)	\$ (10,070)	\$ (11,049)
Per share of Common Stock:				
Basic loss from continuing operations	\$ (0.17)	\$ (0.25)	\$ (0.61)	\$ (0.71)
Basic income from discontinued operations	\$	\$ 0.02	\$	\$ 0.01
Basic net loss available to Common Stock holders	\$ (0.17)	\$ (0.23)	\$ (0.61)	\$ (0.69)
Per share of Common Stock:				
Diluted loss from continuing operations	\$ (0.17)	\$ (0.25)	\$ (0.61)	\$ (0.71)
Diluted income from discontinued operations	\$	\$ 0.02	\$	\$ 0.01
Diluted net loss available to Common Stock holders	\$ (0.17)	\$ (0.23)	\$ (0.61)	\$ (0.69)
Shares used to calculate basic net loss per share	16,758	16,069	16,515	15,928
Shares used to calculate diluted net loss per share	16,758	16,069	16,515	15,928
Stock-based compensation, primarily restricted stock, is included in individual line items above:				
Cost of Behavioral Analytics revenue	\$ 149	\$ 3	\$ 208	\$ 14
Sales, marketing and development	943	524	3,094	1,778
General and administrative	596	342	1,653	1,056
Severance and related costs	29		29	268

See accompanying notes to the Condensed Consolidated Financial Statements.



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**MATTERSIGHT CORPORATION**  
**CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE LOSS**

(Unaudited and in thousands)

	<b>For the Three Months Ended</b>		<b>For the Nine Months Ended</b>	
	<b>September 30, 2013</b>	<b>September 29, 2012</b>	<b>September 30, 2013</b>	<b>September 29, 2012</b>
Net loss	\$ (2,633)	\$ (3,595)	\$ (9,629)	\$ (10,536)
Other comprehensive loss:				
Effect of currency translation	5	(1)		(3)
Comprehensive net loss	\$ (2,628)	\$ (3,596)	\$ (9,629)	\$ (10,539)

See accompanying notes to the Condensed Consolidated Financial Statements.

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**MATTERSIGHT CORPORATION**  
**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**

(Unaudited and in thousands)

	<b>For the Nine Months Ended</b>	
	<b>September 30,</b>	<b>September 29,</b>
	<b>2013</b>	<b>2012</b>
<b>Cash Flows from Operating Activities:</b>		
Net loss	\$ (9,629)	\$ (10,536)
Less: net income from discontinued operations		228
Net loss from continuing operations	(9,629)	(10,764)
Adjustments to reconcile net loss from continuing operations to net cash provided by (used in) operating activities:		
Depreciation and amortization	2,829	2,568
Stock-based compensation	4,955	2,848
Severance and related costs	29	268
Change in fair value of warrant liability	(43)	
Other	2	2
Changes in assets and liabilities:		
Receivables	357	(421)
Prepaid expenses	233	(344)
Other assets	(65)	(219)
Accounts payable	(49)	557
Accrued compensation and related costs	(117)	(162)
Unearned revenue	4,069	(6,044)
Other liabilities	486	86
<b>Total Adjustments</b>	<b>12,686</b>	<b>(861)</b>
Net cash provided by (used in) continuing operations	3,057	(11,625)
Net cash used in discontinued operations		(179)
Net cash provided by (used in) operating activities	3,057	(11,804)
<b>Cash Flows from Investing Activities:</b>		
Capital expenditures and other	(1,168)	(1,777)
Net cash used in continuing investing activities	(1,168)	(1,777)
Net cash used in discontinued investing activities		
Net cash used in investing activities	(1,168)	(1,777)
<b>Cash Flows from Financing Activities:</b>		

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Proceeds from line of credit	2,400	3,691
Repayments from line of credit	(2,400)	
Decrease in restricted cash		1,500
Proceeds from stock compensation and employee stock purchase plans, net	106	455
Purchase of shares of Series B Stock		(3,743)
Principal payments under capital lease obligations	(1,723)	(1,685)
Acquisition of treasury stock	(947)	(942)
Payment of Series B Stock dividends		(595)
Fees from issuance of Common Stock		(49)
Net cash used in continuing financing activities	(2,564)	(1,368)
Net cash used in discontinued financing activities		
Net cash used in financing activities	(2,564)	(1,368)
Effect of exchange rate changes on cash and cash equivalents by continuing operations	(4)	2
Effect of exchange rate changes on cash and cash equivalents by discontinued operations		
Effect of exchange rate changes on cash and cash equivalents	(4)	2
Decrease in cash and cash equivalents	(679)	(14,947)
Cash and cash equivalents, beginning of period	14,419	29,408
Cash and cash equivalents of continuing operations, end of period	\$ 13,740	\$ 14,461
Non-Cash Investing and Financing Transactions:		
Capital lease obligations incurred	\$ 2,767	\$ 1,331
Capital equipment purchased on credit	2,767	1,331
Fair value of warrants classified as liability	617	
Supplemental Disclosures of Cash Flow Information:		
Interest paid	\$ 295	\$ 294

See accompanying notes to the Condensed Consolidated Financial Statements.

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**MATTERSIGHT CORPORATION**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**(Unaudited)**

**Note One General**

In the opinion of management, the accompanying unaudited condensed consolidated financial statements of Mattersight Corporation ( we, Mattersight, or the Company ) include all normal and recurring adjustments necessary for a fair presentation of our condensed consolidated financial position as of September 30, 2013 and December 31, 2012, the condensed consolidated results of our operations for the three months and nine months ended September 30, 2013 and September 29, 2012, the condensed consolidated statements of our comprehensive loss for the three months and nine months ended September 30, 2013 and September 29, 2012, and our condensed consolidated cash flows for the nine months ended September 30, 2013 and September 29, 2012, and are in accordance with United States generally accepted accounting principles ( GAAP ) and in conformity with Securities and Exchange Commission ( SEC ) Article 8-03 of Regulation S-X; provided, that certain information and disclosures normally included in financial statements prepared in accordance with GAAP have been condensed or omitted.

The accompanying unaudited condensed consolidated financial statements should be read in conjunction with the audited consolidated financial statements and the notes thereto in Mattersight s Annual Report on Form 10-K for the fiscal year ended December 31, 2012 filed with the SEC on March 14, 2013. The results of operations for the three and nine months ended September 30, 2013 are not necessarily indicative of the results to be expected for the full year.

The preparation of financial statements in conformity with GAAP requires management to make certain 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 periods. Actual results could differ from those estimates.

**Note Two Summary of Significant Accounting Policies**

For a description of the Company s Summary of Significant Accounting Policies, see Note Two Summary of Significant Accounting Policies of the Notes to Consolidated Financial Statements included in our Annual Report filed on Form 10-K for the year ended December 31, 2012.

In accordance with ASC 480-10 ( Distinguishing Liabilities from Equity ), the Company classified warrants as a liability. The liability is remeasured to fair value at each subsequent reporting date. Increases in fair value are recorded as losses on our condensed consolidated statement of operations, while decreases are recorded as gains. If classified as equity, contingent consideration is not remeasured and subsequent settlement is accounted for within equity. Fair value of the warrants was measured using a Monte Carlo option pricing model and in applying this model certain assumptions were used. See Note Thirteen, Stock Warrants .

**Note Three Discontinued Operations**

The Company sold its Integrated Contact Solutions ( ICS ) Business Unit and eLoyalty registered trademark / trade name to Magellan Acquisition Sub, LLC, a Colorado limited liability company and wholly-owned subsidiary of TeleTech Holdings, Inc., a Delaware corporation, on May 28, 2011, and the Company changed its name from

eLoyalty Corporation to Mattersight Corporation effective May 31, 2011. Therefore, the results of operations of the ICS Business Unit are reported as discontinued operations for all periods presented. Additionally, certain corporate and general costs that had historically been allocated to the ICS Business Unit were reallocated to the Company and are reflected in all periods presented.

The following table summarizes the components included within income from discontinued operations, net of tax, within the Company's Condensed Consolidated Statements of Operations for the periods indicated.

(In millions)	For the Three Months Ended		For the Nine Months Ended			
	September 30, 2013	September 29, 2012	September 30, 2013	September 29, 2012		
Net sales	\$	\$	\$	\$		
Total expenses				(0.1)		
Benefit for income taxes		0.3		0.3		
Income from discontinued operations	\$	\$	0.3	\$	\$	0.2

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Intraperiod tax allocation requires that the provision for income taxes be allocated between continuing operations and other categories of earnings (such as discontinued operations or other comprehensive loss) for each tax jurisdiction. In periods in which there is a year-to-date pre-tax loss from continuing operations and pre-tax income in other categories of earnings, the tax provision is first allocated to the other categories of earnings. A related tax benefit is then recorded in continuing operations. While intraperiod tax allocation in general does not change the overall tax provision, it may result in a gross-up of the individual components, thereby changing the amount of tax provision included in each category. For the three months and nine months ended September 30, 2013, the intraperiod allocation was not applicable because we no longer have any discontinued operations activity. For the three months and nine months ended September 29, 2012, the intraperiod allocation was not applicable because we had a pretax loss in both continuing and discontinued operations. Included in discontinued operations income tax provision for the three and nine months ended September 29, 2012 is a tax benefit of \$0.3 million due to a favorable ruling from the Internal Revenue Service. The Company no longer anticipates any impact on income from discontinued operations due to the sale of the ICS Business Unit.

**Note Four Revenue Recognition****Behavioral Analytics Revenue**

Behavioral Analytics revenue consists of Managed services revenue and Consulting services revenue derived from the performance of the Behavioral Analytics Service and related services (collectively, Behavioral Analytics ).

Managed services revenue consists of planning, deployment, training, and subscription fees derived from Behavioral Analytics contracts. Planning, deployment, and training fees, which are considered to be installation fees related to Behavioral Analytics subscription contracts, are deferred until the installation is complete and are then recognized over the subscription period of the applicable subscription contract. The subscription periods of these contracts generally range from three to five years after the go-live date or, in cases where the Company contracts with a client for a short-term pilot of Behavioral Analytics prior to committing to a longer subscription period, if any, the subscription or pilot periods generally range from three to twelve months after the go-live date. Installation costs incurred are deferred up to an amount not to exceed the amount of deferred installation revenue and additional amounts that are recoverable based on the contractual arrangement. These costs are included in Prepaid expenses and Other long-term assets. Such costs are amortized over the subscription period of the contract. Costs in excess of the foregoing revenue amount are expensed in the period incurred.

The amount of revenue generated from subscription fees is based on a number of factors, such as the number of users to whom the Behavioral Analytics Service is provided, the type and number of Behavioral Analytics offerings deployed to the client, and in some cases, the number of hours of calls analyzed during the relevant month of the subscription period. This revenue is recognized as the service is performed for the client.

Consulting services revenue primarily consists of fees charged to the Company's clients to provide post-deployment follow-on consulting services, which include custom data analysis, the implementation of enhancements, and training. These follow-on consulting services are generally performed for the Company's clients on a fixed-fee basis. Revenue is recognized as the services are performed, with performance generally assessed on the ratio of actual hours incurred to-date compared to the total estimated hours over the entire term of the contract.

**Other Revenue**

Other revenue consists of Marketing Managed Services revenue and CRM Services revenue.

Marketing Managed Services revenue is derived from marketing application hosting. This revenue is generally in the form of fixed monthly fees received from the Company's clients and is recognized as the services are performed for the client. Any related setup fee is recognized over the term of the hosting contract.

CRM Services revenue consists of fees generated from the Company's operational consulting services, which are provided to the Company's clients on a time-and-materials or fixed-fee basis. The Company recognizes revenue as the services are performed for time-and-materials projects. For fixed-fee projects, revenue is recognized based on the ratio of hours incurred to-date compared to the total estimated hours over the entire term of the contract.

**Note Five Stock-Based Compensation**

The Company has two stock-based compensation plans, the Mattersight Corporation 1999 Stock Incentive Plan (the 1999 Plan ) and the Mattersight Corporation Employee Stock Purchase Plan (the ESPP ), each as described more fully in Note Thirteen in the Company's Annual Report filed on Form 10-K for the year ended December 31, 2012.

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	For the Three Months Ended		For the Nine Months Ended	
	September 30, 2013	September 30, 2012	September 30, 2013	September 29, 2012

Stock-based compensation expense (in millions)	\$ 1.7	\$ 0.9	\$ 5.0	\$ 2.8
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The Company recognizes stock-based compensation expense on a straight-line basis over the vesting period. The Company has established its forfeiture rate based on historical experience.

As of September 30, 2013, there were a total of 1,413,493 shares of the Company's common stock, par value \$0.01 per share ( Common Stock ), available for future grants under the 1999 Plan and from treasury stock. The Common Stock is traded on the NASDAQ Global Market under the symbol MATR.

**Restricted Stock**

Restricted stock award activity was as follows for the nine months ended September 30, 2013:

	Shares	Weighted Average Price
Nonvested balance at December 31, 2012	821,363	\$ 6.81
Granted	173,661	\$ 4.56
Vested	(279,383)	\$ 6.34
Forfeited	(192,414)	\$ 6.62
Nonvested balance at September 30, 2013	523,227	\$ 6.39

	For the Three Months Ended		For the Nine Months Ended	
(In millions)	September 30, 2013	September 30, 2012	September 30, 2013	September 29, 2012

Total fair value of restricted and installment stock awards vested	\$ 0.3	\$ 0.5	\$ 1.1	\$ 3.1
Compensation expense related to restricted stock awards	0.6	0.5	1.7	1.9

As of September 30, 2013, there remained \$2.6 million of unrecognized compensation expense related to restricted stock awards. These costs are expected to be recognized over a weighted average period of 1.4 years.



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Option activity was as follows for the nine months ended September 30, 2013:

	<b>Options</b>	<b>Weighted Average Exercise Price</b>
Outstanding as of December 31, 2012	1,766,236	\$ 9.03
Granted	417,500	\$ 4.54
Exercised	(4,498)	\$ 3.47
Forfeited	(100,625)	\$ 5.70
Outstanding as of September 30, 2013	2,078,613	\$ 8.31
Exercisable as of September 30, 2013	1,243,477	\$ 10.13
Outstanding intrinsic value at September 30, 2013 (in millions)	\$	
Exercisable intrinsic value at September 30, 2013 (in millions)	\$	

	<b>For the Three Months Ended</b>		<b>For the Nine Months Ended</b>	
	<b>September 30, 2013</b>	<b>September 29, 2012</b>	<b>September 30, 2013</b>	<b>September 29, 2012</b>
Compensation expense related to option awards (in millions)	\$ 0.3	\$ 0.3	\$ 0.9	\$ 0.8

	<b>For the Three Months Ended</b>		<b>For the Nine Months Ended</b>	
	<b>September 30, 2013</b>	<b>September 29, 2012</b>	<b>September 30, 2013</b>	<b>September 29, 2012</b>
(In millions)				
Total fair value of stock options vested	\$ 0.4	\$ 0.2	\$ 0.9	\$ 0.7
Intrinsic value of stock options exercised		0.1		0.3
Proceeds received from option exercises		0.1		0.3

As of September 30, 2013, there remained \$2.7 million of unrecognized compensation expense related to stock options. These costs are expected to be recognized over a weighted average period of 1.8 years.

The fair value for options granted for the nine months ended September 30, 2013 and September 29, 2012 was estimated on the date of grant using a Black-Scholes option-pricing model. The following assumptions represent the year-to-date weighted average for all option grants issued:

	<b>For the Nine Months Ended</b>	
	<b>September 30, 2013</b>	<b>September 29, 2012</b>
Risk-free interest rates	0.62%	0.58%
Expected dividend yield		
Expected volatility	67%	67%
Expected lives	6 years	6 years

Historical Company information is the primary basis for the selection of expected life, expected volatility, and expected dividend yield assumptions. The risk-free interest rate is selected based on the yields from U.S. Treasury Strips with a remaining term equal to the expected term of the options being valued.

### *Other Stock Compensation*

#### *Employee Stock Purchase Plan*

The ESPP is intended to qualify as an employee stock purchase plan under section 423 of the Internal Revenue Code. Under the ESPP, eligible employees are permitted to purchase shares of Common Stock at below-market prices.

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The purchase period opens on the first day and ends on the last business day of each calendar quarter. The shares of Common Stock issued under the ESPP were as follows:

	For the Three Months Ended		For the Nine Months Ended	
	September 30, 2013	September 29, 2012	September 30, 2013	September 29, 2012
Shares of Common Stock issued	10,242	6,918	31,463	21,221
Expense related to ESPP (in thousands)	\$ 8	\$ 12	\$ 27	\$ 36

The fair value for ESPP purchases for the nine months ended September 30, 2013 and September 29, 2012 was estimated using a Black-Scholes pricing model. The Company used the following year-to-date weighted average assumptions:

	For the Nine Months Ended	
	September 30, 2013	September 29, 2012
Risk-free interest rates	0.06%	0.05%
Expected dividend yield		
Expected volatility	42%	46%
Expected lives	0.25 years	0.24 years

**Salary Replacement Program**

On May 9, 2013, the Compensation Committee of the Board of Directors (the Compensation Committee) approved the Salary Replacement Program (the Program) to be effective from July 1, 2013 through June 30, 2014 (the Effective Period). Participation was mandatory for any employee whose annual base salary was equal to or greater than \$125,000 (each such employee, a Participant). Under the Program, Participants received periodic grants of unrestricted Common Stock (subject to Compensation Committee approval of each grant to the executive officers) in exchange for a 25% reduction in the cash salaries otherwise payable to Participants.

On August 7, 2013, the Compensation Committee terminated the Program. The Company no longer reduces cash salaries for periodic grants of unrestricted Common Stock. Effective October 1, 2013, the Company's executive officers and other affected employees received their full salaries in cash.

A total of 146,267 shares of Common Stock were granted to employees under the Program during the nine months ended September 30, 2013. The Company recorded \$0.6 million of expense for the Program during the three months and nine months ended September 30, 2013.

**Commissions**

The Company paid commissions with shares of unrestricted Common Stock from May 2013 to July 2013. A total of 149,364 and 345,324 shares of unrestricted Common Stock were granted to employees in payment of earned commissions during the three months and nine months ended September 30, 2013. In connection therewith, the Company recorded \$0.1 million and \$0.4 million of expense during the three months and nine months ended

September 30, 2013.

**Note Six Severance and Related Costs**

Severance costs are comprised primarily of contractual salary and related fringe benefits over the severance payment period. Facility costs include losses on contractual lease commitments, net of estimated sublease recoveries, and impairment of leasehold improvements and certain office assets.

For the three months and nine months ended September 30, 2013, the Company recorded \$0.2 million of expense related to severance and related costs for the elimination of one position. For the three months ended September 29, 2012, there was no expense related to severance and related costs. For the nine months ended September 29, 2012, the Company recorded \$0.7 million of expense related to severance and related costs for the elimination of one position.

For the nine months ended September 30, 2013, the Company made cash payments of \$0.2 million related to cost-reduction actions and facility operating expense. During the nine months ended September 29, 2012, the Company made cash payments of \$0.7 million related to cost-reduction actions and facility operating expense.

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The severance and related costs and their utilization for the nine months ended September 30, 2013 was as follows:

(In millions)	<b>Employee Severance</b>	<b>Facilities</b>	<b>Total</b>
<b>Balance, December 31, 2012</b>	\$	\$	\$
Charges	0.2		0.2
Adjustments charged to severance and related costs			
Charged to severance and related costs	0.2		0.2
Payments	(0.2)		(0.2)
Other			
<b>Balance, September 30, 2013</b>	\$	\$	\$

As of September 30, 2013, there was no amount reserved for severance and related costs.

The severance and related costs and their utilization for the nine months ended September 29, 2012 was as follows:

(In millions)	<b>Employee Severance</b>	<b>Facilities</b>	<b>Total</b>
<b>Balance, December 31, 2011</b>	\$	\$	\$
Charges	0.7		0.7
Adjustments charged to severance and related costs			
Charged to severance and related costs	0.7		0.7
Payments	(0.7)		(0.7)
Other			
<b>Balance, September 29, 2012</b>	\$	\$	\$

As of September 29, 2012, there was no amount reserved for severance and related costs.

**Note Seven Current Prepaid Expenses**

Current prepaid expenses primarily consist of deferred costs and prepaid commissions related to Behavioral Analytics contracts. These costs are recognized over the subscription periods of the respective contracts, generally three to five years after the go-live date or, in cases where the Company contracts with a client for a short-term pilot of the Behavioral Analytics Service prior to committing to a longer subscription period, if any, the subscription or pilot periods generally range from three to twelve months after the go-live date. Costs included in current prepaid expenses will be recognized within the next twelve months. Current prepaid expenses consisted of the following:

(In millions)	As of	
	September 30, 2013	December 31, 2012
Deferred costs	\$ 1.3	\$ 1.8
Prepaid commissions	1.3	1.7
Other	1.4	0.9
Total	\$ 4.0	\$ 4.4

**Note Eight Intangible Assets, net**

Intangible assets reflect costs related to patent and trademark applications, Marketing Managed Services customer relationships acquired in 2004, and the 2003 purchase of a license for certain intellectual property. Patent and trademark applications are amortized over 120 months. The other intangible assets are fully amortized. Amortization expense of intangible assets for the three months and nine months ended September 30, 2013 was \$45 thousand and \$ 144 thousand, respectively, and will be \$175 thousand annually thereafter. Amortization expense of intangible assets for the three months and nine months ended September 29, 2012 was \$29 thousand and \$62 thousand, respectively. There was an impairment charge of \$14 thousand for the three months and nine months ended September 30, 2013. There was an impairment charge of \$2 thousand for the nine months ended September 29, 2012.

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(In millions)	As of	
	September 30, 2013	December 31, 2012
Gross intangible assets	\$ 3.1	\$ 2.9
Accumulated amortization of intangible assets	(2.8)	(2.7)
<b>Total</b>	<b>\$ 0.3</b>	<b>\$ 0.2</b>

**Note Nine Other Long-Term Assets**

Other long-term assets primarily consist of deferred costs and prepaid commissions related to Behavioral Analytics. These costs are recognized over the terms of the respective contracts, generally three to five years. Costs included in long-term assets will be recognized over the remaining term of the contracts beyond the first twelve months. Other long-term assets consisted of the following:

(In millions)	As of	
	September 30, 2013	December 31, 2012
Prepaid commissions	\$ 1.9	\$ 1.7
Deferred costs	1.8	1.8
Other	0.9	0.3
<b>Total</b>	<b>\$ 4.6</b>	<b>\$ 3.8</b>

**Note Ten Short-Term Debt**

On August 19, 2013, the Company and its wholly-owned subsidiaries entered into a Loan and Security Agreement with Partners for Growth IV, L.P. ( PfG ) (the Credit Facility ). The Credit Facility is subordinated to the Company's existing \$10.0 million credit facility with Silicon Valley Bank described below and, in combination therewith, increases the Company's aggregate lines of credit to \$15.0 million as of September 30, 2013. The Credit Facility provides for (a) a \$3.0 million revolving line of credit maturing in 2016 (the Tranche A Facility ) and (b) a \$2.0 million convertible term loan (the Tranche B Facility ), which, if advanced, would be funded in two tranches of \$1.0 million, each evidenced by a convertible promissory note (each, a Convertible Note ) maturing five years following the issuance thereof. The Company has not drawn on the Credit Facility as of September 30, 2013.

With respect to the Tranche A Facility, the Company paid a commitment fee upon closing the Credit Facility of \$60 thousand, equal to two percent (2.0%) of the Tranche A Facility commitment, and will pay an annual commitment fee of one percent (1.0%) of the Tranche A Facility commitment in each of 2014 and 2015 and (b) with respect to the Tranche B Facility, the Company paid a commitment fee upon closing the Credit Facility of \$20 thousand, equal to one percent (1.0%) of the Tranche B Facility commitment, and will pay one percent (1.0%) of the Tranche B Facility commitment upon the advance of each Convertible Note. Furthermore, the principal amount outstanding under the Credit Facility, if drawn upon, will accrue interest at a fixed annual rate equal to nine and three quarters percent (9.75%) per annum, payable monthly, which, if the Company meets certain earnings and EBITDA targets, will be reduced to eight and three quarters percent (8.75%) per annum, payable monthly.

On May 30, 2013, the Company, together with its wholly-owned subsidiaries Mattersight Europe Holding Corporation and Mattersight International Holding, Inc., as co-borrowers, entered into an Amended and Restated Loan and Security Agreement with Silicon Valley Bank (the Amended and Restated Credit Facility ). The Amended and Restated Credit Facility (i) extends the maturity date of the \$10.0 million revolving line to 2015; (ii) modifies the borrowing base from one based upon the Company's unrestricted cash to one based upon the Company's available accounts receivable; (iii) provides for a varying interest rate based on the Company's ratio of unrestricted cash to debt; and (iv) requires the Company to maintain a tangible net worth of at least \$3.0 million dollars. The terms and conditions of the Amended and Restated Credit Facility are otherwise substantially the same as those contained in the Loan and Security Agreement, dated June 29, 2012, by and between the Company, the subsidiary borrowers thereto, and Silicon Valley Bank. The \$3.7 million principal amount outstanding under the Amended and Restated Credit Facility will accrue interest at a floating annual rate equal to three quarters of one percentage point (0.75%) above the United States prime rate, payable monthly. In addition, the Company is obligated to pay a fee equal to one-eighth of one percent (0.125%) per annum of the average unused portion of the Amended and Restated Credit Facility, payable quarterly in arrears.



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Short-term debt was \$3.7 million as of September 30, 2013 and interest expense for the three months and nine months ended September 30, 2013 was \$38 thousand and \$120 thousand, respectively. The current interest rate for the quarter ended September 30, 2013 was 4%. The Company was in compliance with all its debt covenants under the Credit Facility and the Amended and Restated Credit Facility as of September 30, 2013.

**Note Eleven Loss Per Share**

The following table sets forth the computation of the loss and shares used in the calculation of basic and diluted loss per share:

(In millions)	<b>For the Three Months Ended</b>	
	<b>September 30, 2013</b>	<b>September 29, 2012</b>
Loss from continuing operations	\$ (2.6)	\$ (3.9)
Dividends related to Series B Stock <sup>(1)</sup>	(0.2)	(0.1)
Loss from continuing operations available to Common Stock holders	(2.8)	(4.0)
Income from discontinued operations		0.3
Net loss available to Common Stock holders	\$ (2.8)	\$ (3.7)
Per common share:		
Basic/diluted loss from continuing operations	\$ (0.17)	\$ (0.25)
Basic/diluted income from discontinued operations	\$	\$ 0.02
Basic/diluted net loss available to Common Stock holders	\$ (0.17)	\$ (0.23)
(In thousands)		
Weighted average shares of Common Stock outstanding	16,758	16,069
Currently antidilutive Common Stock equivalents <sup>(2)</sup>	1,705	1,551
	<b>For the Nine Months Ended</b>	
	<b>September 30, 2013</b>	<b>September 29, 2012</b>
(In millions)		
Loss from continuing operations	\$ (9.7)	\$ (10.8)
Series B Stock fair value over stated value		(0.1)
Dividends related to Series B Stock <sup>(1)</sup>	(0.4)	(0.4)

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Loss from continuing operations available to Common Stock holders	(10.1)	(11.3)
Income from discontinued operations		0.2
Net loss available to Common Stock holders	\$ (10.1)	\$ (11.1)
Per common share:		
Basic/diluted loss from continuing operations	\$ (0.61)	\$ (0.71)
Basic/diluted income from discontinued operations	\$	\$ 0.01
Basic/diluted net loss available to Common Stock holders	\$ (0.61)	\$ (0.69)
(In thousands)		
Weighted average shares of Common Stock outstanding	16,515	15,928
Currently antidilutive Common Stock equivalents <sup>(2)</sup>	1,659	2,184

- (1) The Board of Directors did not declare a dividend payment on the 7% Series B Convertible Preferred Stock, par value \$0.01 per share (the Series B Stock), which was accrued, for the dividend periods July 1, 2012 through December 31, 2012 and January 1, 2013 through June 30, 2013 (the aggregate amount of these dividends was approximately \$0.6 million). The Board of Directors declared a cash dividend of \$0.1785 per share on the Series B Stock for the dividend period January 1, 2012 through June 30, 2012; the semi-annual dividend payment of \$0.3 million for such period was paid on July 2, 2012.
- (2) In periods in which there was a loss, the effect of Common Stock equivalents, which is primarily related to the Series B Stock, was not included in the diluted loss per share calculation as it was antidilutive.

**Table of Contents****Note Twelve Leases*****Capital Leases***

The Company acquired \$2.8 million and \$1.3 million of computer equipment and leasehold improvements using capital leases during the first nine months of 2013 and 2012, respectively. These assets were related primarily to investments in Behavioral Analytics. There was \$1.7 million of depreciation on capital leases in both the first nine months of 2013 and 2012. All capital leases are for terms of either thirty or thirty-six months. The liabilities for these capital leases are included in Other current liabilities and Other long-term liabilities on the balance sheet.

The following is a schedule, by year, of future minimum lease payments under capital leases, together with the present value of the net minimum lease payments as of September 30, 2013:

(In millions)	
<b>Year</b>	<b>Amount</b>
2013	\$ 0.5
2014	1.8
2015	1.2
2016	0.1
<b>Total minimum lease payments</b>	<b>\$ 3.6</b>
Less: estimated executory costs	(0.2)
<b>Net minimum lease payments</b>	<b>\$ 3.4</b>
Less: amount representing interest	(0.4)
<b>Present value of minimum lease payments</b>	<b>\$ 3.0</b>

**Capital leases consisted of the following:**

(In millions)	As of	
	September 30, 2013	December 31, 2012
Other current liabilities	\$ 1.6	\$ 1.6
Other long-term liabilities	1.4	0.7
<b>Total</b>	<b>\$ 3.0</b>	<b>\$ 2.3</b>

**Note Thirteen Stock Warrants**

The Company granted to PfG, certain affiliates of PfG, and Silicon Valley Bank warrants (the PfG Warrants) to purchase up to \$600 thousand of Common Stock. The PfG Warrants were issued in connection with the execution of the Credit Facility, and the Company received the sum of approximately \$4 thousand, which the parties agreed was fair consideration for the PfG Warrants, in connection with such issuance.

The holders of the PfG Warrants (or their permitted successors and assigns), are entitled to exercise or exchange the PfG Warrants at any time through August 19, 2018, for the number of duly authorized, validly issued, fully paid and non-assessable shares of Common Stock as up to \$600 thousand would purchase at the exercise price (described below), upon the terms and subject to the provisions of the PfG Warrants. The exercise price of the PfG Warrants is equal to the lesser of (a) \$2.79 and (b) the 10-Day VWAP as of the date that is 6 months following the issue date thereof.

The Company also granted warrants (the Conditional Warrants ) to PfG to purchase up to \$2.0 million of Common Stock, which may be exercised, at the same exercise price as is specified for the Convertible Notes, only if both (i) the Tranche B Facility is advanced and (ii) the Company prepays the Tranche B Facility, in whole or in part, prior to the maturity date thereof. The Conditional Warrants may be exercised only in an amount equal to the principal amount of such prepayment. As of September 30, 2013, the Tranche B Facility had not been advanced.

The PfG Warrants and the Conditional Warrants, and the shares of Common Stock to be issued upon exercise of the PfG Warrants and the Conditional Warrants, have not been and will not be registered under the Securities Act of 1933, as amended, or any state securities law and were issued pursuant to an exemption from registration provided by Section 4(2) of the Securities Act and/or Regulation D promulgated thereunder. Neither the PfG Warrants and the Conditional Warrants, nor the shares of Common Stock issuable upon exercise of the PfG Warrants and the Conditional Warrants, may be subsequently offered or sold within the United States absent registration or exemption from such registration requirements and compliance with applicable state laws.

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A summary of the status of the Warrants at September 30, 2013, and the changes during the nine months then ended, is presented in the following table:

	<b>Issue Date</b>	<b>Shares of Common Stock, par value \$0.01, represented by Warrants</b>	<b>Exchange Price</b>	<b>Expiration Date</b>
Outstanding as of December 31, 2012				
Granted	August 19, 2013	Number of Shares as up to \$600,000 would purchase at the Exchange Price, subject to adjustment	Lower of \$2.79 And 10-day VWAP at the Issue Date plus 6 months, subject to adjustment	August 19, 2018
Exercised				
Expired				
Outstanding as of September 30, 2013		Number of Shares as up to \$600,000 would purchase at the Exchange Price, subject to adjustment	Lower of \$2.79 And 10-day VWAP at the Issue Date plus 6 months, subject to adjustment	August 19, 2018
Exercisable as of September 30, 2013		Number of Shares as up to \$600,000 would purchase at the Exchange Price,	Lower of \$2.79 And 10-day VWAP at the Issue Date plus 6 months, subject to adjustment	August 19, 2018

subject to  
adjustment

The fair value of the warrant liability was estimated using the Monte Carlo option-pricing model and the following assumptions:

	<b>September 30, 2013</b>	<b>August 19, 2013</b>
Risk-free interest rates	1.39%	1.39%
Expected dividend yield		
Expected volatility	58%	59%
Expected lives	4.9 years	5.0 years
Weighted average stock price	\$ 3.70	\$ 3.90

#### **Note Fourteen Segment Information**

The Company operates in a single business segment, focused primarily on Behavioral Analytics.

#### **Note Fifteen Fair Value Measurements**

The Company reports certain assets and liabilities at fair value. Fair value is an exit price and establishes a three-tier valuation hierarchy for ranking the quality and reliability of the information used to determine fair values. The first tier, Level 1, uses quoted market prices in active markets for identical assets or liabilities. Level 2 uses inputs, other than quoted market prices for identical assets or liabilities in active markets, which are observable either directly or indirectly. Level 3 uses unobservable inputs in which there are little or no market data, and requires the entity to develop its own assumptions. A financial asset or liability's classification within the hierarchy is determined based on the lowest level input that is significant to the fair value measurement.

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The following table provides the assets and liabilities carried at fair value measured on a recurring basis:

(In millions)	Fair Value Measurements at September 30, 2013 Using			
	Total carrying	Quoted Prices in	Other	Significant
	at September 30,	Active	Observable	Unobservable
	2013	Markets	(Level	(Level 3)
		(Level 1)	2)	
Money market fund	\$ 13.0	\$ 13.0	\$	\$
Warrant liability	0.6			0.6

(In millions)	Fair Value Measurements at December 31, 2012 Using			
	Total carrying	Quoted Prices in	Other	Significant
	at December 31,	Active	Observable	Unobservable
	2012	Markets	(Level	(Level 3)
		(Level 1)	2)	
Money market fund	\$ 13.4	\$ 13.4	\$	\$

The following table represents the activity in the Company's Level 3 warrants during the three months ended September 30, 2013:

(In millions)	September 30,
	2013
Level 3 warrants, beginning of period	\$
Addition - PfG Warrants, initial fair value	0.6
Change in fair value of warrant liability	
Level 3 warrants, end of period	\$ 0.6

**Note Sixteen Fair Value of Financial Instruments**

The carrying values of cash and cash equivalents, accounts receivable, accounts payable, and short-term debt approximated their fair values as of September 30, 2013 and December 31, 2012 due to the short-term nature of these instruments.

**Note Seventeen Recent Accounting Pronouncements**

In July 2013, the Financial Accounting Standards Board ( FASB ) issued ASU No. 2013-11, Income Taxes (Topic 740) Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Carryforward Exists. ASU 2013-11 provides guidance on the financial statement presentation of an unrecognized tax benefit when a net operating loss carryforward, a similar tax loss, or a tax credit carryforward exists. An unrecognized tax benefit should be presented in the financial statements as a reduction to a deferred tax asset for a net operating loss carryforward, a similar tax loss, or a tax credit carryforward with certain exceptions, in which case such an

unrecognized tax benefit should be presented in the financial statements as a liability. The amendments in this ASU are effective for reporting periods beginning after December 15, 2013. The adoption of this ASU is not expected to have a material impact on the Company's condensed consolidated financial statements.

**Note Eighteen    Litigation and Other Contingencies**

The Company is a party to various agreements, including all client contracts, under which it may be obligated to indemnify the other party with respect to certain matters, including, but not limited to, indemnification against third-party claims of infringement of intellectual property rights with respect to software and other deliverables provided by the Company in the course of providing services to its clients. These obligations may be subject to various limitations on the remedies available to the other party, including, without limitation, limits on the amounts recoverable and the time during which claims may be made, and may be supported by indemnities given to the Company by applicable third parties. Payment by the Company under these indemnification clauses is generally subject to the other party making a claim that is subject to challenge by the Company and dispute resolution procedures specified in the particular agreement. Historically, the Company has not been obligated to pay any claim for indemnification under its agreements, and management is not aware of future indemnification payments that it would be obligated to make.



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Under its By-Laws, subject to certain exceptions, the Company has agreed to indemnify its officers and directors for certain events or occurrences while the officer or director is, or was, serving at its request in such capacity or in certain related capacities. The Company has separate indemnification agreements with each of its directors and officers that requires it, subject to certain exceptions, to indemnify them to the fullest extent authorized or permitted by its By-Laws and the Delaware General Corporation Law. The maximum potential amount of future payments the Company could be required to make under these indemnification agreements is unlimited; however, the Company has a director and officer liability insurance policy that limits its exposure and enables it to recover a portion of any future amounts paid. As a result of its insurance policy coverage, the Company believes the estimated fair value of these indemnification agreements is minimal. The Company had no liabilities recorded for these agreements as of September 30, 2013.

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

### **Background**

Mattersight Corporation (together with its subsidiaries and predecessors, Mattersight, we, us, or the Company) is a leader in enterprise analytics focused on customer and employee interactions and behaviors. Mattersight's Behavioral Analytics Service captures and analyzes customer and employee interactions, employee desktop data, and other contextual information to optimally route customers to the best available employee, improve operational performance, and predict future customer and employee outcomes. Mattersight's analytics are based on millions of proprietary algorithms and the application of unique behavioral models. The Company's SaaS+ delivery model combines analytics in the cloud with deep customer partnerships to drive significant business value. Mattersight's solutions are used by leading companies in the healthcare, insurance, financial services, telecommunications, cable, utilities, education, hospitality, and government industries.

Through the performance of Behavioral Analytics, the Company generates two types of revenue:

- (1) Managed services revenue, which is recurring, annuity revenue from long-term (generally three- to five-year) contracts and pilots, which are shorter-term (generally three to twelve months), and includes subscription and amortized deployment revenue; and
- (2) Consulting services revenue, which is generally project-based and sold on a time-and-materials or fixed-fee basis and includes follow-on consulting services revenue.

Set forth below is a more detailed description of the capabilities that the Company currently offers.

### ***Behavioral Analytics***

The Company's multi-channel technology captures the unstructured data of voice interactions (conversations), related customer and employee data, and employee desktop activity, and applies millions of proprietary algorithms against those interactions. Each interaction contains hundreds of attributes that get scored and ultimately detect patterns of behavior or business process that provide the transparency and predictability necessary to enhance revenue, improve the customer experience, improve efficiency, and predict and navigate outcomes. Adaptive across industries, programs, and industry-specific processes, the Company's Behavioral Analytics offerings enable its clients to drive measurable economic benefit through the improvement of contact center performance, customer satisfaction and retention, fraud reduction, and streamlined back office operations. Specifically, through its Behavioral Analytics

offerings, Mattersight helps its clients:

Automatically measure customer satisfaction and agent performance on every analyzed call;

Identify and understand customer personality;

Identify optimal customer/employee behavioral pairing for call routing;

Improve rapport between agent and customer;

Reduce call handle times while improving customer satisfaction;

Identify opportunities to improve self-service applications;

Improve cross-sell and up-sell success rates;

Improve the efficiency and effectiveness of collection efforts;

Measure and improve supervisor effectiveness and coaching;

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Improve agent effectiveness by analyzing key attributes of desktop usage;

Predict likelihood of customer attrition;

Predict customer satisfaction and Net Promoter Scores® without customer surveys;

Predict likelihood of debt repayment;

Predict likelihood of a sale or cross-sell; and

Identify fraud callers and improve authentication processes.

The Company has designed a highly-scalable, flexible, and adaptive application platform to enable the Company to implement and operate its Behavioral Analytics offerings for its clients. These offerings are primarily delivered through a SaaS+ model, as a managed subscription service from which Mattersight derives Managed services revenue and Consulting services revenue. Managed services revenue consists of revenue from deployment and subscription services and Consulting services revenue consists of revenue from post-deployment follow-on services, including coaching, training, and custom data analysis.

In addition to our Behavioral Analytics offerings, Mattersight also generates revenue from the following services:

(1) Marketing Managed Services, which consist of marketing application hosting services, from which the Company derives Managed services revenue; and

(2) CRM Services, which consist of operational consulting services that enhance business performance through improved process efficiencies and redesign of workflows, from which the Company derives Consulting services revenue.

## **Types of Revenue**

### ***Managed Services Revenue***

Growth in Managed services revenue is primarily driven by the execution of new Behavioral Analytics contracts, under which we deploy and provide ongoing managed services related to our proprietary Behavioral Analytics System and provide related Business Monitoring services. Based on each client's business requirements, the Behavioral Analytics System is configured and integrated into the client's environment and then deployed in either a remote-hosted or, in one case, an on-premise hosted environment. Thereafter, the client's selection of our Behavioral Analytics offerings is provided, on a subscription basis, for a period that is generally three to five years after the go-live date or, in the cases where the Company contracts with a client for a short-term pilot of the Behavioral Analytics Service prior to committing to a longer subscription period, if any, the subscription or pilot periods generally range from three to twelve months after the go-live date. The fees and costs related to the initial deployment are deferred and amortized over the term of the contract.

We also generate Managed services revenue from Marketing Managed Services, specifically, from hosted customer and campaign data management. This source of Managed services revenue will continue to diminish over time as we focus on growth through Behavioral Analytics.

### ***Consulting Services Revenue***

In addition to the Consulting services revenue generated by our Behavioral Analytics contracts, we derive a portion of this type of revenue from CRM Services for long-standing accounts. We expect Consulting services revenue from CRM Services to continue to diminish over time as demand for these services continues to decline and we focus on growth through Behavioral Analytics. We bill for Consulting services on a time-and-materials or fixed-fee basis.

### **Business Outlook**

Based upon Mattersight's business development efforts and third-party market research, we believe there has been a fundamental shift in the way large enterprises view data. The trends suggest that large enterprises today appreciate that there is value in data that can be derived from their front and back offices, but they have not yet established efficient and effective methods to capture, analyze, and create value from this data. We seek to help large enterprises capitalize on this data with our Behavioral Analytics solutions and, as a leader in this rapidly growing market, we believe we are uniquely positioned to capitalize on this opportunity. We believe the market potential in the U.S. for enterprise analytics, including our current offerings, is significant and we estimate it to be less than 5% penetrated.

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Our business strategy to increase revenue, profitability, and capture market share includes the following elements:

Win business with new clients, focusing on predictive behavioral routing;

Develop partnerships and strategic alliances to expand sales leverage, improve brand awareness, and reach new industries while providing value to our mutual clients;

Increase up-sell and cross-sell ratios by deepening and broadening our relationships with existing clients;

Continue to invest in innovative proprietary technology, new applications, and delivery methods;

Continue bookings growth and improve operating leverage; and

Expand our sales and marketing efforts with seasoned enterprise sales agents and strategic marketing professionals.

Resulting from our delivery of measurable economic benefit to our clients, we have seen increased penetration within existing accounts, due to an increase in adoption of our base Behavioral Analytics offerings across separate and distinct business units, as well as the adoption of new applications within existing business units. For this reason, we will continue to focus on further penetrating what we estimate to be a large existing base market with a less expensive cost of acquisition. In addition, our strategy to further invest in sales and marketing, coinciding with the fundamental shift in enterprise data utilization described above, has led to an increasing number of discussions with potential new clients and strategic partners.

### ***Managed Services Backlog***

The Behavioral Analytics Managed services backlog was \$81.1 million as of September 30, 2013 and \$89.1 million as of December 31, 2012. This decrease in backlog is due to the value of Behavioral Analytics revenue in the first nine months of 2013 combined with an adjustment for the impact of the termination of a portion of an existing contract exceeding the amount of Behavioral Analytics contracts signed in the first nine months of 2013.

Mattersight uses the term *backlog* to reflect the estimated future amount of Managed services revenue related to its Managed services contracts. The value of these contracts is based on anticipated usage volumes over the anticipated contract term. The anticipated contract term is based on the fixed term of the contract, plus contractually agreed upon, but optional, extension or renewal periods. Actual volumes may be greater or less than anticipated. In addition, these contracts typically are cancellable without cause based on the customer making a substantial early termination payment or forfeiture of prepaid contract amounts.

### **Critical Accounting Policies and Estimates**

Our management's discussion and analysis of financial condition and results of operations is based upon our condensed consolidated financial statements, which have been prepared in accordance with GAAP. The preparation of

these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenue, and expenses, and related disclosure of contingent assets and liabilities. On an ongoing basis, we evaluate our estimates, including those related to the costs and timing of completion of client projects, our ability to collect accounts receivable, the timing and amounts of expected payments associated with cost reduction activities, and the ability to realize our net deferred tax assets, contingencies, and litigation. We base our estimates on historical experience and on various other assumptions that we believe to be reasonable under the circumstances. Actual results may differ from these estimates under different assumptions or conditions.

We believe the following critical accounting policies affect the more significant judgments and estimates used in the preparation of our condensed consolidated financial statements.

### ***Revenue Recognition***

#### **Behavioral Analytics Revenue**

Behavioral Analytics revenue consists of Managed services revenue and Consulting services revenue derived from the performance of Behavioral Analytics.

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Managed services revenue consists of planning, deployment, training, and subscription fees derived from Behavioral Analytics contracts. Planning, deployment, and training fees, which are considered to be installation fees related to Behavioral Analytics subscription contracts, are deferred until the installation is complete and are then recognized over the subscription period of the applicable subscription contract. The subscription periods of these contracts generally range from three to five years after the go-live date or, in cases where the Company contracts with a client for a short-term pilot of Behavioral Analytics prior to committing to a longer subscription period, if any, the subscription or pilot periods generally range from three to twelve months after the go-live date. Installation costs incurred are deferred up to an amount not to exceed the amount of deferred installation revenue and additional amounts that are recoverable based on the contractual arrangement. These costs are included in Prepaid expenses and Other long-term assets. Such costs are amortized over the subscription period of the contract. Costs in excess of the foregoing revenue amount are expensed in the period incurred.

The amount of revenue generated from subscription fees is based on a number of factors, such as the number of users to whom the Behavioral Analytics Service is provided, the type and number of Behavioral Analytics offerings deployed to the client, and in some cases, the number of hours of calls analyzed during the relevant month of the subscription period. This revenue is recognized as the service is performed for the client.

Consulting services revenue primarily consists of fees charged to the Company's clients to provide post-deployment follow-on consulting services, which include custom data analysis, the implementation of enhancements, and training. These follow-on consulting services are generally performed for the Company's clients on a fixed-fee basis. Revenue is recognized as the services are performed, with performance generally assessed on the ratio of actual hours incurred to-date compared to the total estimated hours over the entire term of the contract.

## **Other Revenue**

Other revenue consists of Marketing Managed Services revenue and CRM Services revenue.

Marketing Managed Services revenue is derived from marketing application hosting. This revenue is generally in the form of fixed monthly fees received from the Company's clients and is recognized as the services are performed for the client. Any related setup fee would be recognized over the term of the hosting contract.

CRM Services revenue consists of fees generated from the Company's operational consulting services, which are provided to the Company's clients on a time-and-materials or fixed-fee basis. The Company recognizes revenue as the services are performed for time-and-materials projects. For fixed-fee projects, revenue is recognized based on the ratio of hours incurred to-date compared to the total estimated hours over the entire term of the contract.

## **Reimbursed Expenses**

Reimbursed expenses revenue includes billable costs related to travel and other out-of-pocket expenses incurred while performing services for the Company's clients. The cost of third-party product and support may be included within this category if the transaction does not satisfy the requirements for gross reporting. An equivalent amount of reimbursable expenses is included in Cost of revenue.

## **Unearned Revenue**

Payments received for Managed services contracts in excess of the amount of revenue recognized for these contracts are recorded as unearned revenue until revenue recognition criteria are met.

### **Allowance for Doubtful Accounts**

The Company maintains allowances for doubtful accounts for estimated losses resulting from clients not paying for unpaid or disputed invoices for contractual services provided. Additional allowances may be required if the financial condition of our clients deteriorates.

### ***Stock-Based Compensation***

Stock-based compensation cost is measured at the grant date based on the fair value of the award and is recognized as expense over the vesting period. Determining fair value of stock-based awards at the grant date requires certain assumptions. The Company uses historical information as the basis for the selection of expected life, expected volatility, expected dividend yield assumptions, and anticipated forfeiture rates. The risk-free interest rate is selected based on the yields from U.S. Treasury Strips with a remaining term equal to the expected term of the options being valued.

### ***Severance and Related Costs***

Severance and related costs includes cost-reduction actions, principally consisting of personnel reductions and an office consolidation. The portion of the accruals that related to employee severance represents contractual severance for identified employees and generally is not subject to a significant revision. The portion of the accruals that related to office space reductions, office closures, and associated contractual lease obligations are based in part on assumptions and estimates of the timing and amount of sublease rentals, which may be affected by overall economic and local market conditions. To the extent estimates of the success of our sublease efforts changed, adjustments increasing or decreasing the related accruals have been recognized.



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***Income Taxes***

We have recorded income tax valuation allowances on our net deferred tax assets to account for the unpredictability surrounding the timing of realization of our U.S. and non-U.S. net deferred tax assets due to uncertain economic conditions. The valuation allowances may be reversed at a point in time when management determines realization of these tax assets has become more likely than not, based on a return to predictable levels of profitability.

The Company uses an asset and liability approach for financial accounting and reporting of income taxes. Deferred income taxes are provided when tax laws and financial accounting standards differ with respect to the amount of income for the year, the basis of assets and liabilities and for tax loss carryforwards. The Company does not provide U.S. deferred income taxes on earnings of U.S. or foreign subsidiaries, which are expected to be indefinitely reinvested.

The Company may recognize the tax benefit from an uncertain tax position only if it is more likely than not that the tax position will be sustained on examination by the taxing authorities, based on the technical merits of the position. The tax benefits recognized in the financial statements from such a position should be measured based on the largest benefit that has a greater than 50% likelihood of being realized upon ultimate settlement. Significant judgment is used to determine the likelihood of the benefit. There is additional guidance on derecognition, classification, interest and penalties on income taxes, accounting in interim periods, and disclosure requirements.

Intraperiod tax allocation requires that the provision for income taxes be allocated between continuing operations and other categories of earnings (such as discontinued operations or other comprehensive loss) for each tax jurisdiction. In periods in which there is a year-to-date pre-tax loss from continuing operations and pre-tax income in other categories of earnings, the tax provision is first allocated to the other categories of earnings. A related tax benefit is then recorded in continuing operations. While intraperiod tax allocation in general does not change the overall tax provision, it does affect the amount of tax provision included in each category. For the three months and nine months ended September 30, 2013, the intraperiod allocation was not applicable because we no longer have any discontinued operations activity. For the three months and nine months ended September 29, 2012, the intraperiod allocation was not applicable because we had a pretax loss in both continuing and discontinued operations.

***Other Significant Accounting Policies***

For a description of the Company's other significant accounting policies, see Note Two Summary of Significant Accounting Policies of the Notes to Consolidated Financial Statements included in our Annual Report filed on Form 10-K for the year ended December 31, 2012.

**Forward-Looking Statements**

Statements in this Form 10-Q that are not historical facts are forward-looking statements and are made pursuant to the safe harbor provisions 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, which may be identified by use of words such as plan, may, might, believe, expect, intend, could, would, should, words and terms of similar meaning, in connection with any discussion of our prospects, financial statements, business, financial condition, revenues, results of operations, or liquidity, involve risks and uncertainties that could cause actual results to differ materially from those described in the forward-looking statements. In addition to other factors and matters contained or incorporated in this document, important factors that could cause actual results or events to differ materially from those indicated by such forward-looking statements include, without limitation, those noted under Risk Factors included in Part I Item 1A of our Form 10-K for the year ended December 31, 2012, as well

as the following:

Uncertainties associated with the attraction of, and the ability to execute contracts with, new clients, the continuation of existing, and execution of new, engagements with existing clients, and the timing of related client commitments;

Reliance on a relatively small number of clients for a significant percentage of our revenue;

Risks involving the variability and predictability of the number, size, scope, cost, and duration of, and revenue from, client engagements;

Management of the other risks associated with complex client projects and new service offerings, including execution risk; and

Management of growth and development of, and introduction of, new service offerings.

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We cannot guarantee any future results, levels of activity, performance, or achievements. The statements made in this Form 10-Q represent our views as of the date of this Form 10-Q, and it should not be assumed that the statements made in this Form 10-Q remain accurate as of any future date. Moreover, we assume no obligation to update forward-looking statements, except as may be required by law.

### **Third Quarter of 2013 Compared with Third Quarter of 2012**

Services revenue is total revenue excluding reimbursable expenses that are billed to our clients. Our services revenue increased \$0.6 million, or 8%, to \$8.6 million in the third quarter of 2013 from \$8.0 million in the third quarter of 2012. The increase in revenue was mainly due to the payment by a customer of an early termination fee in the third quarter of 2013, in connection with the cancellation of a contract.

Behavioral Analytics revenue increased \$0.6 million, or 8%, to \$8.3 million in the third quarter of 2013 from \$7.7 million in the third quarter of 2012. The increase in revenue was mainly due to the payment by a customer of an early termination fee in the third quarter of 2013, in connection with the cancellation of a contract.

Other revenue remained constant at \$0.3 million in the third quarter of both 2013 and 2012.

The Company's top five clients accounted for 68% of total revenue in the third quarter of 2013 and 65% of total revenue in the third quarter of 2012. The top 10 clients accounted for 91% of total revenue in the third quarter of 2013 and 89% of total revenue in the third quarter of 2012. In the third quarter of 2013 and 2012, there were four and three clients, respectively, that each accounted for 10% or more of total revenue. In the third quarter of 2013, Vangent, Inc., Progressive Casualty Insurance Company, Allstate Insurance Company, and United HealthCare Services, Inc., accounted for 20%, 16%, 13%, and 11% of total revenue, respectively. In the third quarter of 2012, Vangent, Inc., Allstate Insurance Company, and Progressive Casualty Insurance Company accounted for 20%, 14%, and 13% of total revenue, respectively. Higher concentration of revenue with a single client or a limited group of clients creates increased revenue risk if one of these clients significantly reduces its demand for our services.

### ***Cost of Revenue Before Reimbursed Expenses, Exclusive of Depreciation and Amortization***

#### **Cost of Services**

Cost of services primarily consists of labor costs, including salaries, fringe benefits, and incentive compensation, royalties, and other client-related third-party outside services. Cost of services excludes depreciation and amortization.

Cost of Behavioral Analytics revenue was \$2.7 million, or 33% of Behavioral Analytics revenue in the third quarter of 2013, compared to \$2.8 million, or 37% of Behavioral Analytics revenue, in the third quarter of 2012. The favorable decrease in cost and percentage was primarily due to improved productivity in our delivery organization resulting in lower compensation costs and better leverage of our cost structure supporting our subscription clients.

Cost of other revenue was \$0.2 million, or 54% of Other revenue in the third quarter of 2013, compared to \$0.2 million, or 50% of Other revenue, in the third quarter of 2012.

#### ***Sales, Marketing and Development***

Sales, marketing and development expenses consist primarily of salaries, incentive compensation, commissions, and employee benefits for business development, account management, marketing, and product development personnel. The personnel costs included in this item are net of any labor costs directly related to the generation of

revenue, which are represented in Cost of Services.

Sales, marketing and development expenses decreased \$1.0 million, or 18%, to \$4.9 million in the third quarter of 2013 from \$5.9 million in the third quarter of 2012. This decrease is primarily related to lower headcount versus the prior period.

***General and Administrative***

General and administrative expenses consist primarily of salaries, incentive compensation, and employee benefits for administrative personnel, as well as facilities costs, a provision for uncollectible amounts, and costs for our corporate technology infrastructure and applications.

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General and administrative expenses increased \$0.2 million, or 15%, to \$2.2 million in the third quarter of 2013 from \$2.0 million in the third quarter of 2012. This increase is due to slightly higher compensation expense and increased legal expense.

### ***Severance and Related Costs***

Severance and related costs includes cost-reduction actions, principally consisting of personnel reductions and an office consolidation. The cost-reduction actions taken during fiscal year 2012 resulted in annual cash savings of \$0.3 million. Costs related to office space reductions and office closures were paid pursuant to contractual lease terms through January 2012.

In the third quarter of 2013, there was \$0.2 million of expense which was related to severance and related costs for the elimination of one position. There were no severance and related costs in the third quarter of 2012.

### ***Depreciation and Amortization***

Depreciation and amortization remained constant at \$0.9 million in the third quarter of both 2013 and 2012.

### ***Operating Loss***

Primarily as a result of the factors described above, we experienced an operating loss of \$2.5 million for the third quarter of 2013, compared to an operating loss of \$3.8 million for the third quarter of 2012.

### ***Interest and Other Expense, Net***

Non-operating interest and other expense was \$0.1 million for both the third quarters of 2013 and 2012. In the third quarter of 2013 and 2012, the expense was primarily related to interest expense on our short-term debt and capital lease obligation.

### ***Income Tax (Provision) Benefit***

The income tax provision was less than \$0.1 million in the third quarters of 2013 and 2012. As of September 30, 2013, total net deferred tax assets of \$67.2 million were fully offset by a valuation allowance. The level of uncertainty in predicting when we will achieve profitability, sufficient to utilize our net U.S. and non-U.S. operating losses and realize our remaining deferred tax assets, requires that an income tax valuation allowance be recognized in the financial statements.

### ***Income from Discontinued Operations***

There was no income from discontinued operations in the third quarter of 2013. The income from discontinued operations was \$0.3 million in the third quarter of 2012 due to a favorable IRS ruling on a previously accrued income tax liability.

### ***Net Loss Available to Common Stockholders***

We reported net loss available to holders of our Common Stock of \$2.8 million in the third quarter of 2013 compared to net loss available to holders of our Common Stock of \$3.7 million in the third quarter of 2012. Accrued dividends to holders of our Series B Stock were \$0.1 million in the third quarters of 2013 and 2012. In the third quarter of 2013,

there was net loss of \$0.17 per share on a basic and diluted basis, compared to net loss of \$0.23 per share on a basic and diluted basis in the third quarter of 2012.

**First Nine Months of 2013 Compared with First Nine Months of 2012**

Services revenue is total revenue excluding reimbursable expenses that are billed to our clients. Our services revenue increased \$0.2 million, or 1%, to \$25.0 million in the first nine months of 2013, from \$24.8 million in the first nine months of 2012.

Behavioral Analytics revenue was \$24.1 million in the first nine months of 2013 and was \$23.8 million in the first nine months of 2012. The \$0.3 million, or 1%, increase in Behavioral Analytics revenue in the first nine months of 2013 was primarily due to revenue associated with new client agreements, expansion at several existing clients and the payment by a customer of an early termination fee in connection with the cancellation of a contract.

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Other revenue remained constant at \$1.0 million in the first nine months of 2013 and 2012.

The Company's top five clients accounted for 68% of total revenue in the first nine months of 2013 and 67% of total revenue in the first nine months of 2012. The top 10 clients accounted for 90% of total revenue in the first nine months of 2013 and 89% of total revenue in the first nine months of 2012. In the first nine months of 2013, there were four clients that accounted for 10% or more of total revenue, whereas three clients accounted for 10% or more of total revenue in the first nine months of 2012. In the first nine months of 2013, Vangent, Inc., Progressive Casualty Insurance Company, Allstate Insurance Company, and United HealthCare Services, Inc., accounted for 19%, 15%, 14%, and 11% of total revenue, respectively. In the first nine months of 2012, Vangent, Inc., Allstate Insurance Company, and Progressive Casualty Insurance Company accounted for 19%, 16%, and 13% of total revenue, respectively. Higher concentration of revenue with a single client or a limited group of clients creates increased revenue risk if one of these clients significantly reduces its demand for our services.

### ***Cost of Revenue Before Reimbursed Expenses, Exclusive of Depreciation and Amortization***

#### **Cost of Services**

Cost of services primarily consists of labor costs, including salaries, fringe benefits, and incentive compensation, royalties, and other client-related third-party outside services. Cost of services excludes depreciation and amortization.

Cost of Behavioral Analytics revenue was \$8.0 million, or 33% of Behavioral Analytics revenue in the first nine months of 2013, compared to \$9.0 million, or 38% of Behavioral Analytics revenue, in the first nine months of 2012. The favorable decrease in cost and percentage was primarily due to improved productivity in our Delivery organization resulting in lower compensation costs and better leverage of our cost structure supporting our subscription clients.

Cost of other revenue was \$0.5 million, or 53% of Other revenue in both the first nine months of 2013 and 2012.

#### ***Sales, Marketing and Development***

Sales, marketing and development expenses consist primarily of salaries, incentive compensation, commissions, and employee benefits for business development, account management, marketing, and product development personnel. The personnel costs included in this item are net of any labor costs directly related to the generation of revenue, which are represented in Cost of services.

Sales, marketing and development expenses decreased \$0.1 million, to \$16.5 million in the first nine months of 2013 from \$16.6 million in the first nine months of 2012. This decrease is primarily due to lower compensation expense.

#### ***General and Administrative***

General and administrative expenses consist primarily of salaries, incentive compensation, and employee benefits for administrative personnel, as well as facilities costs, a provision for uncollectible amounts, and costs for our corporate technology infrastructure and applications.

General and administrative expenses increased \$0.7 million, or 12%, to \$6.6 million in the first nine months of 2013 from \$5.9 million in the first nine months of 2012. This increase is primarily due to higher compensation expense.

#### ***Severance and Related Costs***

Severance and related costs includes cost-reduction actions, principally consisting of personnel reductions and an office consolidation. The cost-reduction actions taken during fiscal year 2012 resulted in annual cash savings of \$0.3 million. Costs related to office space reductions and office closures were paid pursuant to contractual lease terms through January 2012.

In the first nine months of 2013, there was \$0.2 million of expense which was related to severance and related costs for the elimination of one position. In the first nine months of 2012, the \$0.7 million of expense was related to severance and related costs for the elimination of one position.

***Depreciation and Amortization***

Depreciation and amortization increased \$0.2 million, to \$2.8 million in the first nine months of 2013 compared to \$2.6 million in the first nine months of 2012. The increase of \$0.2 million in depreciation and amortization is primarily related to an increased rate of investment for the first nine months of 2013.



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### ***Operating Loss***

Primarily as a result of the factors described above, we experienced an operating loss of \$9.5 million for the first nine months of 2013, compared to an operating loss of \$10.4 million for the first nine months of 2012.

### ***Interest and Other Expense, Net***

Non-operating interest and other expense was \$0.3 million of expense in the first nine months of 2013 and 2012. In the first nine months of 2013 and 2012, the \$0.3 million of expense was primarily related to interest expense on our short-term debt and capital lease obligation.

### ***Income Tax Benefit (Provision)***

The income tax benefit was \$0.2 million in the first nine months of 2013 and the tax provision was less than \$0.1 million in the first nine months of 2012. The income tax benefit in the first nine months of 2013 was due to a favorable tax ruling on a previously accrued income tax liability. As of September 30, 2013, total net deferred tax assets of \$67.2 million were fully offset by a valuation allowance. The level of uncertainty in predicting when we will achieve profitability, sufficient to utilize our net U.S. and non-U.S. operating losses and realize our remaining deferred tax assets, requires that an income tax valuation allowance be recognized in the financial statements.

### ***Income from Discontinued Operations***

There was no income from discontinued operations in the first nine months of 2013. The income from discontinued operations in the first nine months of 2012 was \$0.2 million due to a favorable IRS ruling on a previously accrued income tax liability partially offset by settlement costs relating to a former employee of the ICS Business Unit.

### ***Net Loss Available to Common Stockholders***

We reported net loss available to holders of Common Stock of \$10.1 million in the first nine months of 2013 compared to net loss available to holders of Common Stock of \$11.0 million in the first nine months of 2012. Accrued dividends to holders of our Series B Stock were \$0.4 million in both the first nine months of 2013 and 2012. In the first nine months of 2013, there was net loss of \$0.61 per share on a basic and diluted basis, compared to net loss of \$0.69 per share on a basic and diluted basis in the first nine months of 2012.

## **Liquidity and Capital Resources**

### ***Introduction***

Our principal capital requirements are to fund working capital needs, capital expenditures for Behavioral Analytics and infrastructure requirements, and other revenue generation and growth investments. As of September 30, 2013, our principal capital resources consisted of our cash and cash equivalents balance of \$13.7 million, which includes \$0.2 million in foreign bank accounts.

The decrease in cash during the first nine months of 2013 was primarily the result of the net loss before non-cash items, capital lease principal payments, capital expenditures, and the acquisition of treasury stock, partially offset by a \$4.1 million increase in unearned revenue. Prior to June 30, 2012, restricted cash was primarily used as collateral for letters of credit issued in support of future capital lease obligations. See [Credit Facility](#) description below.

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The decrease in cash during the first nine months of 2012 was primarily the result of the net loss before non-cash items, a decrease in unearned revenue reflecting the recognition of previously deferred revenue, capital expenditures, cash dividend payments on Series B Stock, acquisition of treasury stock, and capital lease principal payments, partially offset by an increase in accounts payable.

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### ***Cash Flows from Operating Activities***

Net cash provided by operating activities of continuing operations during the first nine months of 2013 was \$3.1 million and cash used in operating activities of continuing operations during the first nine months of 2012 was \$11.6 million. During the first nine months of 2013, net cash provided by operating activities consisted primarily of a \$4.1 million increase in unearned revenue, partially offset by the net loss before non-cash items of \$1.9 million.

During the first nine months of 2012, cash outflows of \$11.6 million from operating activities consisted primarily of the net loss before non-cash items of \$5.0 million and a \$6.0 million decrease in unearned revenue reflecting the recognition of previously deferred revenue, partially offset by an increase in accounts payable of \$0.6 million.

There was no net cash used in operating activities of discontinued operations during the first nine months of 2013. Net cash used in operating activities of discontinued operations during the first nine months of 2012 was \$0.2 million.

Days Sales Outstanding ( DSO ) was 23 days at September 30, 2013, compared to 26 days at December 31, 2012, an improvement of three days. Because a high percentage of our revenue is dependent on a relatively small number of clients, delayed payments by a few of our larger clients could result in a reduction of our available cash, which in turn may cause fluctuation in our DSO. We do not expect any significant collection issues with our clients; see *Accounts Receivable Customer Concentration* for additional information on cash collections.

As of September 30, 2013, there were no outstanding liabilities for severance and related costs.

### ***Cash Flows from Investing Activities***

The Company used \$1.2 million of cash in continuing investing activities during the first nine months of 2013 compared to \$1.8 million of cash in continuing investing activities during the first nine months of 2012.

Capital expenditures were primarily used to purchase computer hardware and software during the first nine months of 2013 and 2012, respectively. We currently expect to incur new capital investments of between \$4.0 million and \$5.0 million for fiscal year 2013 and plan on funding approximately \$3.0 million to \$3.8 million of these purchases with capital leases.

There was no net cash used in discontinued investing activities during the first nine months of 2013 and 2012.

### ***Cash Flows from Financing Activities***

Net cash used in continuing financing activities was \$2.6 million during the first nine months of 2013 compared to \$1.4 million during the first nine months of 2012.

The \$2.6 million of net cash used during the first nine months of 2013 was primarily attributable to: (i) \$1.7 million of principal payments under our capital lease obligations and (ii) \$0.9 million of cash used to acquire treasury stock.

Net cash outflows of \$1.4 million during the first nine months of 2012 were primarily attributable to: \$3.7 million to purchase shares of Series B Stock, \$1.7 million of principal payments under our capital lease obligations; \$0.9 million of cash used to acquire treasury stock; and \$0.6 million for cash dividend payments on Series B Stock partially offset by proceeds from our revolving line of credit agreement of \$3.7 million and a decrease in restricted cash of \$1.5 million.

There was no net cash used in discontinued financing activities during the first nine months of 2013 and 2012.

Historically, we have not paid cash dividends on our Common Stock, and we do not expect to do so in the future. The Board of Directors did not declare a dividend payment on Series B Stock, which was accrued, for the dividend periods July 1, 2012 through December 31, 2012 and January 1, 2013 through June 30, 2013 (the aggregate amount of these dividends was approximately \$0.6 million). A cash dividend on the Series B Stock of \$0.3 million was paid on January 3, 2012, for the dividend period July 1, 2011 through December 31, 2011 and a cash dividend of \$0.3 million was paid on July 2, 2012, for the period January 1, 2012 through June 30, 2012. Under the terms of the Certificate of Designations for the Series B Stock, unpaid dividends are cumulative and accrue at the rate of 7% per annum, payable semi-annually in January and July. The amount of each dividend accrual will be decreased by any conversions of the Series B Stock into Common Stock, as such conversions require the Company to pay accrued but unpaid dividends at the time of conversion. Conversions of Series B Stock became permissible at the option of the holder after June 19, 2002.

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Pursuant to a tender offer commenced in the first quarter of 2012, Mattersight purchased 19,758 shares of Series B Stock, at a price of \$8.71 per share (representing \$8.60 per share plus accrued and unpaid dividends), for an aggregate cost of approximately \$172,092, excluding fees and expenses related to the tender offer. These shares represented approximately 1.2% of the Series B Stock outstanding as of April 13, 2012.

The Company expects to acquire between \$0.1 million and \$0.2 million of treasury stock during the fourth quarter of 2013 to meet employee tax obligations associated with the Company's stock-based compensation programs.

***Liquidity***

Our near-term capital resources consist of our current cash balance, together with anticipated future cash flows, financing from capital leases, and our revolving line of credit (See *Credit Facility* below). Our balance of cash and cash equivalents was \$13.7 million as of September 30, 2013.

We anticipate that our current unrestricted cash resources, together with operating revenue and capital lease financing, should be sufficient to satisfy our short-term working capital and capital expenditure needs for the next twelve months. Management will continue to assess opportunities to maximize cash resources by actively managing our cost structure and closely monitoring the collection of our accounts receivable. If, however, our operating activities, capital expenditure requirements, or net cash needs differ materially from current expectations due to uncertainties surrounding the current capital market, credit and general economic conditions, competition, or the termination of a large client contract, then there is no assurance that we would have access to additional external capital resources on acceptable terms.

***Partners for Growth Credit Facility***

On August 19, 2013, the Company and its wholly-owned subsidiaries entered into a Loan and Security Agreement with Partners for Growth IV, L.P. ( *PfG* ) (the *Credit Facility* ). The *Credit Facility* is subordinated to the Company's existing \$10.0 million credit facility with Silicon Valley Bank described below and, in combination therewith, increases the Company's aggregate lines of credit to \$15.0 million as of September 30, 2013. The *Credit Facility* provides for (a) a \$3.0 million revolving line of credit maturing in 2016 (the *Tranche A Facility* ) and (b) a \$2 million convertible term loan (the *Tranche B Facility* ), which, if advanced, would be funded in two tranches of \$1.0 million, each evidenced by a convertible promissory note (each, a *Convertible Note* ) maturing five years following the issuance thereof. Each *Convertible Note* would convert, at the option of the holder, into Common Stock at an exercise price of at least the 10-day volume weighted average per share of Common Stock ( *10-Day VWAP* ) as of the date on which such *Note* is issued. If issued, the *Convertible Notes*, and the shares of Common Stock to be issued upon exercise of the *Convertible Notes*, will not be registered under the Securities Act of 1933, as amended, or any state securities law and will be issued pursuant to an exemption from registration provided by Section 4(2) of the Securities Act and/or Regulation D promulgated thereunder. Neither the *Convertible Notes*, nor the shares of Common Stock issuable upon exercise of *Convertible Notes*, may be subsequently offered or sold within the United States absent registration or exemption from such registration requirements and compliance with applicable state laws. The Company has not drawn on the *Credit Facility* as of September 30, 2013.

With respect to the *Tranche A Facility*, the Company paid a commitment fee upon closing the *Credit Facility* of \$60 thousand, equal to two percent (2.0%) of the *Tranche A Facility* commitment, and will pay an annual commitment fee of one percent (1.0%) of the *Tranche A Facility* commitment in each of 2014 and 2015 and (b) with respect to the *Tranche B Facility*, the Company paid a commitment fee upon closing the *Credit Facility* of \$20 thousand, equal to one percent (1.0%) of the *Tranche B Facility* commitment, and will pay one percent (1.0%) of the *Tranche B Facility* commitment upon the advance of each *Convertible Note*. Furthermore, the principal amount outstanding under the

Credit Facility, if drawn upon, will accrue interest at a fixed annual rate equal to nine and three quarters percent (9.75%) per annum, payable monthly, which, if the Company meets certain earnings and EBITDA targets, will be reduced to eight and three quarters percent (8.75%) per annum, payable monthly.

The Credit Facility imposes usual and customary events of defaults and restrictions on actions of the Company and its subsidiaries, and provides that, upon the occurrence of an event of default, payment of all amounts payable under the Credit Facility may be accelerated and/or the lenders' commitments may be terminated. In addition, upon the occurrence of certain insolvency or bankruptcy related events of default, all amounts payable under the Credit Facility will automatically become immediately due and payable, and the lenders' commitments will automatically terminate.

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In connection with the execution of the Credit Facility, the Company granted warrants (the PfG Warrants ) to purchase up to \$600 thousand of Common Stock to certain affiliates of PfG and to Silicon Valley Bank. The PfG Warrants may be exercised at any time through the expiration thereof in 2018, at an exercise price equal to the lesser of (a) the 10-Day VWAP as of the issue date of the PfG Warrants and (b) the 10-Day VWAP as of the date that is 6 months following the issue date thereof. The Company also granted warrants (the Conditional Warrants ) to purchase up to \$2.0 million of Common Stock to PfG, which may be exercised, at the same exercise price as is specified for the Convertible Notes, only if both (a) the Tranche B Facility is advanced and (b) the Company prepays the Tranche B Facility, in whole or in part, prior to the maturity date thereof. The Conditional Warrants may be exercised only in an amount equal to the principal amount of such prepayment. The PfG Warrants and the Conditional Warrants, and the shares of Common Stock to be issued upon exercise of the PfG Warrants and the Conditional Warrants, have not been and will not be registered under the Securities Act of 1933, as amended, or any state securities law and were issued pursuant to an exemption from registration provided by Section 4(2) of the Securities Act and/or Regulation D promulgated thereunder. Neither the PfG Warrants and the Conditional Warrants, nor the shares of Common Stock issuable upon exercise of the PfG Warrants and the Conditional Warrants, may be subsequently offered or sold within the United States absent registration or exemption from such registration requirements and compliance with applicable state laws.

***Silicon Valley Bank Credit Facility***

On May 30, 2013, the Company, together with its wholly-owned subsidiaries Mattersight Europe Holding Corporation and Mattersight International Holding, Inc., as co-borrowers, entered into an Amended and Restated Loan and Security Agreement with Silicon Valley Bank (the Amended and Restated Credit Facility ). The Amended and Restated Credit Facility (i) extends the maturity date of the \$10.0 million revolving line to 2015; (ii) modifies the borrowing base from one based upon the Company s unrestricted cash to one based upon the Company s available accounts receivable; (iii) provides for a varying interest rate based on the Company s ratio of unrestricted cash to debt; and (iv) requires the Company to maintain a tangible net worth of at least \$3 million. The terms and conditions of the Amended and Restated Credit Facility are otherwise substantially the same as those contained in the Loan and Security Agreement, dated June 29, 2012, by and between the Company, the subsidiary borrowers thereto, and Silicon Valley Bank.

The \$3.7 million principal amount outstanding under the Amended and Restated Credit Facility at September 30, 2013, will accrue interest at a floating annual rate equal to three quarters of one percentage point (0.75%) above the United States prime rate, currently accruing at a four percent (4%), payable monthly. In addition, the Company is obligated to pay a fee equal to one-eighth of one percent (0.125%) per annum of the average unused portion of the Amended and Restated Credit Facility, payable quarterly in arrears.

The Amended and Restated Credit Facility imposes various restrictions on the Company, including usual and customary limitations on the ability of the Company or any of its subsidiaries to incur debt and to grant liens upon their assets, and prohibits certain consolidations, mergers, and sales and transfers of assets by the Company and its subsidiaries. The Amended and Restated Credit Facility includes usual and customary events of default for facilities of this nature (with customary grace periods, as applicable) and provides that, upon the occurrence of an event of default, payment of all amounts payable under the Amended and Restated Credit Facility may be accelerated and/or the lenders commitments may be terminated. In addition, upon the occurrence of certain insolvency or bankruptcy related events of default, all amounts payable under the Amended and Restated Credit Facility will automatically become immediately due and payable, and the lenders commitments will automatically terminate.

See Note Ten Short-Term Debt of the Notes to Condensed Consolidated Financial Statements for further discussion.

***Accounts Receivable Customer Concentration***

As of September 30, 2013, four clients, United HealthCare Services, Inc., CVS Pharmacy, Inc., Direct Energy, LP, and Allstate Insurance Company, accounted for 19%, 14%, 14%, and 12% of total gross accounts receivable, respectively. Of these amounts, we have collected 39% from United HealthCare Services, Inc., 47% from CVS Pharmacy, Inc., 0% from Direct Energy, LP, and 73% from Allstate Insurance Company, through November 5, 2013. Of the total September 30, 2013 gross accounts receivable, we have collected 38% as of November 5, 2013. Because we have a high percentage of our revenue dependent on a relatively small number of clients, delayed payments by a few of our larger clients could result in a reduction of our available cash.



**Table of Contents****Capital Lease Obligations**

Capital lease obligations as of September 30, 2013 and December 31, 2012 were \$3.0 million and \$2.3 million, respectively. We are a party to a capital lease agreement with a leasing company to lease hardware and software. We expect to incur new capital lease obligations of between \$3.0 million to \$3.8 million for fiscal year 2013 as we continue to expand our investment in the infrastructure for Behavioral Analytics and predictive behavioral routing.

**Contractual Obligations**

Cash will also be required for operating leases and non-cancellable purchase obligations, as well as various commitments reflected as liabilities on our balance sheet as of September 30, 2013. These commitments are as follows:

(In millions)		Less Than 1	1 3	3 5	More Than 5
<b>Contractual Obligations</b>	<b>Total</b>	<b>Year</b>	<b>Years</b>	<b>Years</b>	<b>Years</b>
Letters of credit	\$ 0.3	\$ 0.3	\$	\$	\$
Operating leases	2.4	1.2	1.1	0.1	
Capital leases	3.6	1.9	1.7		
Purchase obligations	1.5	1.5			
<b>Total</b>	<b>\$ 7.8</b>	<b>\$ 4.9</b>	<b>\$ 2.8</b>	<b>\$ 0.1</b>	<b>\$</b>

**Letters of Credit**

The amounts set forth in the chart above reflect standby letters of credit issued as collateral for capital leases. Specifically, these amounts reflect the face amount of these letters of credit that expire in each period presented.

**Leases**

The amounts set forth in the chart above reflect future principal, interest, and executory costs of the leases entered into by the Company for technology and office equipment, as well as office and data center space. Liabilities for the principal portion of the capital lease obligations are reflected on our balance sheet as of September 30, 2013 and December 31, 2012.

**Purchase Obligations**

Purchase obligations include \$0.9 million of commitments reflected as liabilities on our balance sheet as of September 30, 2013, as well as \$0.6 million of non-cancellable obligations to purchase goods or services in the future. As of December 31, 2012, purchase obligations include \$0.9 million of commitments reflected as liabilities on our balance sheet, as well as \$0.9 million of non-cancellable obligations to purchase goods or services in the future.

**Recent Accounting Pronouncements**

In July 2013, the Financial Accounting Standards Board ( FASB ) issued ASU No. 2013-11, Income Taxes (Topic 740) Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax

Carryforward Exists. ASU 2013-11 provides guidance on the financial statement presentation of an unrecognized tax benefit when a net operating loss carryforward, a similar tax loss, or a tax credit carryforward exists. An unrecognized tax benefit should be presented in the financial statements as a reduction to a deferred tax asset for a net operating loss carryforward, a similar tax loss, or a tax credit carryforward with certain exceptions, in which case such an unrecognized tax benefit should be presented in the financial statements as a liability. The amendments in this ASU are effective for reporting periods beginning after December 15, 2013. The adoption of this ASU is not expected to have a material impact on the Company's condensed consolidated financial statements.

### **Item 3. Quantitative and Qualitative Disclosures about Market Risk**

There have been no material changes in market risk as of September 30, 2013 from that described in the Company's Annual Report filed on Form 10-K for the year ended December 31, 2012.

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### **Item 4. Controls and Procedures**

#### ***Evaluation of Disclosure Controls and Procedures***

Mattersight maintains disclosure controls and procedures that have been designed to ensure that information required to be disclosed by the Company in the reports it files or submits under the Securities Exchange Act of 1934 is recorded, processed, summarized, and reported within the time periods specified in the rules and forms of the SEC and such information is accumulated and communicated to Company management, including its principal executive officers, to allow timely decisions regarding required disclosure. The Company's Chief Executive Officer and Chief Financial Officer evaluated 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, as required by Rule 13a-15 of the Securities Exchange Act of 1934. Based on this evaluation, our Chief Executive Officer and Chief Financial Officer concluded that, as of the end of the period covered by this report, the Company's disclosure controls and procedures were effective.

As of the last business day of our second fiscal quarter (June 30, 2013), our public float, as calculated in accordance with Rule 12b-2 under the Securities Exchange Act of 1934, as amended ( Rule 12b-2 ), was less than \$50 million. As such, we became a smaller reporting company (as defined in Rule 12b-2) on such date. In addition to being a smaller reporting company, we will continue to be an accelerated filer (as defined in Rule 12b-2) through the end of the current fiscal year. At the end of the current fiscal year, we will cease to be an accelerated filer and will only be a smaller reporting company.

#### ***Changes in Internal Control over Financial Reporting***

During the first quarter of 2013, we completed the implementation of a new accounting and management information system. There have been no changes in Mattersight's internal control over financial reporting that occurred during the third quarter of 2013 that has materially affected, or is reasonably likely to affect materially, the Company's internal control over financial reporting.

### **Part II. Other Information**

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

See discussion under Note Eighteen "Litigation and Other Contingencies" to the Notes to the Condensed Consolidated Financial Statements included in Item 1 of Part I of this Quarterly Report on Form 10-Q, which is incorporated herein by reference.

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

There have been no material changes with respect to the factors disclosed in our Annual Report filed on Form 10-K for the year ended December 31, 2012.

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

##### ***Repurchase of Equity Securities***

The following table provides information relating to the Company's purchase of shares of its Common Stock in the third quarter of 2013. All of these purchases reflect shares withheld to satisfy tax withholding obligations related to stock awarded under the Salary Replacement Program or vestings under other stock programs. The Company has not

adopted a Common Stock repurchase plan or program.

<b>Period</b>	<b>Total Number of Shares Purchased</b>	<b>Average Price Paid Per Share</b>
July 1, 2013 July 31, 2013	48,854	\$ 2.92
August 1, 2013 August 31, 2013	24,216	\$ 3.75
September 1, 2013 September 30, 2013	3,440	\$ 3.75
<b>Total</b>	76,510	\$ 3.22

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**Item 6. Exhibits**

- 4.1 Warrant to purchase Mattersight Corporation common stock dated August 19, 2013, issued to PFG Equity Investors, LLC (incorporated by reference to Exhibit 4.1 to the Company's 8-K filed on August 23, 2013).
- 4.2 Warrant to purchase Mattersight Corporation common stock dated August 19, 2013, issued to Partners for Growth IV, L.P. (incorporated by reference to Exhibit 4.2 to the Company's 8-K filed on August 23, 2013).
- 4.3 Warrant to purchase Mattersight Corporation common stock dated August 19, 2013, issued to Silicon Valley Bank (incorporated by reference to Exhibit 4.3 to the Company's 8-K filed on August 23, 2013).
- 4.4 Conditional Warrant to purchase Mattersight Corporation common stock dated August 19, 2013, issued to Partners for Growth IV, L.P. (incorporated by reference to Exhibit 4.4 to the Company's 8-K filed on August 23, 2013).
- 10.1 Loan and Security Agreement between Partners for Growth IV, L.P., Mattersight Corporation, Mattersight Europe Holding Corporation, and Mattersight International Holding, Inc., dated August 19, 2013 (incorporated by reference to Exhibit 10.1 to the Company's 8-K filed on August 23, 2013).
- 10.2 Second Amendment to Executive Employment Agreement, dated August 8, 2013, between David R. Gustafson and Mattersight Corporation (incorporated by reference to Exhibit 10.1 to the Company's 8-K filed on August 13, 2013).
- \*\*31.1 Certification of Kelly D. Conway under Section 302 of the Sarbanes-Oxley Act of 2002.
- \*\*31.2 Certification of Mark Iserloth under Section 302 of the Sarbanes-Oxley Act of 2002.
- \*\*32.1 Certification of Kelly D. Conway and Mark Iserloth under Section 906 of the Sarbanes-Oxley Act of 2002.
- \*\*101 The following materials from our Quarterly Report on Form 10-Q for the quarter ended September 30, 2013 are formatted in eXtensible Business Reporting Language (XBRL): (i) condensed consolidated balance sheets, (ii) condensed consolidated statements of operations, (iii) condensed consolidated statements of comprehensive loss, (iv) condensed consolidated statements of cash flows, and (v) notes to the unaudited condensed consolidated financial statements.

\*\* Filed herewith.

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**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, on November 7, 2013.

**MATTERSIGHT CORPORATION**

By */s/* MARK ISERLOTH  
Mark Iserloth  
Vice President and Chief Financial Officer  
(Duly authorized signatory and  
Principal Financial Officer)