ULTIMATE SOFTWARE GROUP INC
Form 10-Q
November 09, 2012
Table of Contents

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

FORM 10-Q

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

For the quarterly period ended September 30, 2012

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

For the transition period from _______ to _______
Commission file number: 0-24347

THE ULTIMATE SOFTWARE GROUP, INC.
(Exact name of Registrant as specified in its charter)

Delaware	65-0694077
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
2000 Ultimate Way, Weston, FL	33326
(Address of principal executive offices)	(Zip Code)

(954) 331 - 7000
(Registrant's telephone number, including area code)

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

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes þ 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 (§232.405 of this chapter) during the preceding twelve months (or for such shorter period that the Registrant was required to submit and post such files). Yes þ 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 definitions of "large accelerated filer," "accelerated filer," and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer þ	Accelerated filer o
Non-accelerated filer o (Do not check if a smaller reporting company)	Smaller reporting company o

Indicate by check mark whether the Registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes ¨ Noþ

As of November 1, 2012, there were 27,301,600 shares of the Registrant’s common stock, par value $0.01, outstanding.

Table of Contents

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

Table of Contents

PART 1 – FINANCIAL INFORMATION
ITEM 1. Financial Statements
THE ULTIMATE SOFTWARE GROUP, INC. AND SUBSIDIARIES
UNAUDITED CONDENSED CONSOLIDATED BALANCE SHEETS
(In thousands, except share data)

	As of September 30, 2012	As of December 31, 2011
ASSETS		
Current assets:		
Cash and cash equivalents	$73,143	$46,149
Investments in marketable securities	8,709	7,584
Accounts receivable, net of allowance for doubtful accounts of $475 for 2012 and 2011	57,472	56,186
Prepaid expenses and other current assets	24,689	22,944
Deferred tax assets, net	1,353	1,277
Total current assets before funds held for customers	165,366	134,140
Funds held for customers	144,196	118,660
Total current assets	309,562	252,800
Property and equipment, net	35,547	24,486
Capitalized software, net	752	1,765
Goodwill	3,025	3,025
Investments in marketable securities	1,069	1,546
Other assets, net	16,329	15,056
Deferred tax assets, net	19,637	20,142
Total assets	$385,921	$318,820
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$4,912	$6,265
Accrued expenses	17,577	11,589
Deferred revenue	83,334	83,416
Capital lease obligations	3,096	2,694
Other borrowings	2,362	—
Total current liabilities before customer funds obligations	111,281	103,964
Customer funds obligations	144,196	118,660
Total current liabilities	255,477	222,624
Deferred revenue	1,720	3,147
Deferred rent	2,919	3,384
Capital lease obligations	2,641	2,175
Other borrowings	2,765	—
Income taxes payable	1,866	1,866
Total liabilities	267,388	233,196
Stockholders' equity:		
Preferred Stock, $.01 par value, 2,000,000 shares authorized, no shares issued or outstanding	—	—
Series A Junior Participating Preferred Stock, $.01 par value, 500,000 shares authorized, no shares issued or outstanding	—	—
Common Stock, $.01 par value, 50,000,000 shares authorized, 30,881,229 and 30,204,440 shares issued in 2012 and 2011, respectively	309	302

Additional paid-in capital	266,371	242,100
Accumulated other comprehensive income (loss)	240	(57)
Accumulated deficit	(39,637)	(47,971)
	227,283	194,374
Treasury stock, 3,941,813 shares, at cost, for 2012 and 2011	(108,750)	(108,750)
Total stockholders’ equity	118,533	85,624
Total liabilities and stockholders’ equity	$385,921	$318,820

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

1

Table of Contents

THE ULTIMATE SOFTWARE GROUP, INC. AND SUBSIDIARIES
UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF INCOME
(In thousands, except per share amounts)

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2012	2011	2012	2011
Revenues:				
Recurring	$67,505	$54,689	$193,014	$156,639
Services	15,127	12,794	46,161	38,284
License	—	267	915	1,537
Total revenues	82,632	67,750	240,090	196,460
Cost of revenues:				
Recurring	19,390	16,521	57,729	46,757
Services	16,454	13,073	47,820	39,106
License	—	61	208	334
Total cost of revenues	35,844	29,655	105,757	86,197
Gross profit	46,788	38,095	134,333	110,263
Operating expenses:				
Sales and marketing	17,218	15,002	53,327	47,649
Research and development	14,065	13,256	45,750	37,593
General and administrative	6,224	4,995	18,495	16,370
Total operating expenses	37,507	33,253	117,572	101,612
Operating income	9,281	4,842	16,761	8,651
Other (expense) income:				
Interest and other expense	(178)	(64)	(354)	(365)
Other income, net	47	17	90	77
Total other expense, net	(131)	(47)	(264)	(288)
Income before income taxes	9,150	4,795	16,497	8,363
Provision for income taxes	(4,493)	(3,710)	(8,163)	(6,057)
Net income	$4,657	$1,085	$8,334	$2,306
Net income per share:				
Basic	$0.17	$0.04	$0.31	$0.09
Diluted	$0.16	$0.04	$0.29	$0.08
Weighted average shares outstanding:				
Basic	26,852	25,767	26,634	25,733
Diluted	28,495	27,747	28,312	27,790

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

Table of Contents

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

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2012	2011	2012	2011
Net income	$4,657	$1,085	$8,334	$2,306
Other comprehensive income :				
Unrealized gain (loss) on investments in marketable available for sale securities	5	(2)	3	(6)
Unrealized gain (loss) on foreign currency translation adjustments	372	(266)	297	(214)
Other comprehensive income (loss), before tax	377	(268)	300	(220)
Income tax (expense) benefit related to items of other comprehensive income	(2)	1	(2)	2
Other comprehensive income (loss), net of tax	$375	$(267)	$298	$(218)
Comprehensive income	$5,032	$818	$8,632	$2,088

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

Table of Contents

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

	For the Nine Months Ended September 30, 2012	2011
Cash flows from operating activities:		
Net income	$8,334	$2,306
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	9,961	8,688
Provision for doubtful accounts	722	1,220
Non-cash stock-based compensation expense	14,117	11,359
Income taxes	7,933	5,933
Excess tax benefit from stock-based payments	(7,504)	(4,323)
Changes in operating assets and liabilities:		
Accounts receivable	(2,008)	(262)
Prepaid expenses and other current assets	(620)	(2,789)
Other assets	(1,273)	(2,440)
Accounts payable	(1,353)	466
Accrued expenses and deferred rent	5,523	2,183
Deferred revenue	(1,509)	1,285
Net cash provided by operating activities	32,323	23,626
Cash flows from investing activities:		
Purchases of property and equipment	(12,243)	(10,728)
Purchases of marketable securities	(10,706)	(10,801)
Maturities of marketable securities	10,058	10,122
Net purchases of securities with customer funds	(25,536)	(27,821)
Net cash used in investing activities	(38,427)	(39,228)
Cash flows from financing activities:		
Repurchases of Common Stock	—	(17,310)
Excess tax benefits from stock-based payments	7,504	4,323
Shares acquired to settle employee tax withholding liability	(5,076)	(3,874)
Principal payments on capital lease obligations	(2,504)	(2,238)
Repayments of other borrowings	(214)	—
Net increase in customer fund obligations	25,536	27,821
Net proceeds from issuances of Common Stock	7,555	8,421
Net cash provided by financing activities	32,801	17,143
Effect of exchange rate changes on cash	297	(214)
Net increase in cash and cash equivalents	26,994	1,327
Cash and cash equivalents, beginning of period	46,149	40,889
Cash and cash equivalents, end of period	$73,143	$42,216
Supplemental disclosure of cash flow information:		
Cash paid for interest	$308	$184
Cash paid for income taxes	$365	$547

Supplemental disclosure of non-cash financing activities:

Ultimate entered into capital lease obligations to acquire new equipment totaling $3.4 million and $2.3 million for the nine months ended September 30, 2012 and September 30, 2011, respectively.

Ultimate purchased perpetual licenses with third-party vendors, totaling $6.5 million, payable over a three-year period, of which payments totaling $2.5 million were made during the nine months ended September 30, 2012.

4

Table of Contents

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

Table of Contents

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

1. Nature of Operations

The Ultimate Software Group, Inc. and subsidiaries ("Ultimate," "we," "us" or "our") is a leading cloud provider of people management solutions. Ultimate's UltiPro software ("UltiPro") is a comprehensive software as a service ("SaaS") - or cloud-based solution delivered primarily to organizations based in the United States and Canada and designed to deliver the functionality businesses need to manage the complete employment life cycle from recruitment to retirement. UltiPro is marketed as two solution suites, based on company size. UltiPro Enterprise ("Enterprise") is designed to address the needs of companies with 1,000 or more employees. UltiPro Workplace ("Workplace") is designed for companies with fewer than 1,000 employees. UltiPro is marketed primarily through our Enterprise and Workplace direct sales teams.

2. Basis of Presentation, Consolidation and the Use of Estimates

The accompanying unaudited condensed consolidated financial statements of Ultimate have been prepared, without audit, pursuant to the rules and regulations of the Securities and Exchange Commission (the "SEC"). Certain information and footnote disclosures normally included in financial statements prepared in accordance with U.S. generally accepted accounting principles ("GAAP") have been condensed or omitted pursuant to such rules and regulations. The information in this quarterly report should be read in conjunction with Ultimate's audited consolidated financial statements and notes thereto included in Ultimate's Annual Report on Form 10-K for the fiscal year ended December 31, 2011 filed with the SEC on February 29, 2012 (the "Form 10-K").

The unaudited condensed consolidated financial statements included herein reflect all adjustments (consisting only of normal, recurring adjustments) which are, in the opinion of Ultimate's management, necessary for a fair presentation of the information for the periods presented. The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Interim results of operations for the three and nine months ended September 30, 2012 are not necessarily indicative of operating results for the full fiscal year or for any future periods.

The unaudited condensed consolidated financial statements reflect the financial position and operating results of Ultimate and include its wholly-owned subsidiaries. Intercompany accounts and transactions have been eliminated in consolidation.

3. Summary of Significant Accounting Policies and Recent Accounting Pronouncements

Summary of Significant Accounting Policies

Ultimate's significant accounting policies discussed in Note 3 to its audited consolidated financial statements for the fiscal year ended December 31, 2011, included in the Form 10-K, have not significantly changed, except as disclosed below:

Computer Software Development Costs

Certain computer software development costs are capitalized in the accompanying unaudited consolidated balance sheets. We follow different accounting guidance rules for software capitalization purposes, depending on whether the underlying software is for external use or internal use.

Computer software development costs related to software developed for external use falls under the accounting guidance of ASC Topic 985-20, Costs of Software to Be Sold, Leased, or Marketed, in which capitalization begins upon the establishment of technological feasibility. For software costs that are capitalized in accordance with ASC Topic 985-20, technological feasibility is typically established upon completion of a working model. Capitalization ends and amortization begins when the related developed software is ready for general release to our customers. Amortization periods for software capitalized under this subtopic are generally five years. We have begun amortization for all capitalized software that falls under this guidance. Capitalized software falling under ASC Topic 985-20 is related to our former licensed products, which is presented in the unaudited consolidated balance sheets as capitalized software. There were no research and development expenses capitalized under ASC Topic 985-20 during the three and nine months ended September 30, 2012 and September 30, 2011. Annual amortization is based on the greater of the amount computed using (a) the ratio that current gross revenues for the related product bears to the total of current and anticipated future gross revenues for that product or (b) the straight-line

Table of Contents

method over the remaining estimated economic life of the product including the period being reported on. Capitalized software is amortized using the straight-line method over the estimated useful lives of the assets, which is typically five years. Ultimate evaluates the recoverability of capitalized software based on estimated future gross revenues reduced by the estimated costs of completing the products and of performing maintenance and customer support. If Ultimate's gross revenues were to be significantly less than its estimates, the net realizable value of Ultimate's capitalized software would be impaired, which could result in the write-off of all or a portion of the unamortized balance of such capitalized software.

Computer software development costs related to software developed for internal use falls under the accounting guidance of ASC Topic 350-40, Intangibles Goodwill and Other–Internal Use Software, in which computer software costs are expensed as incurred during the preliminary project stage and capitalization begins in the application development stage once the capitalization criteria are met. Costs associated with post implementation activities are expensed as incurred. Costs capitalized during the application development stage include external direct costs of materials and services consumed in developing or obtaining internal-use software and payroll and payroll-related costs for employees who are directly associated with and who devote time to the internal-use computer software. In addition to capitalizing costs for software (which are used by Ultimate in its general operations, for internal purposes), we also capitalize costs under ASC Topic 350-40 for certain software development projects related to our suite of products sold to our customers exclusively on a subscription basis under our SaaS offering of UltiPro (the “SaaS Offering”) . During the three and nine months ended September 30, 2012, we capitalized $2.6 million of computer software development costs related to a development project to be sold in the future as a SaaS product only. There were no such costs capitalized in the three and nine months ended September 30, 2011. These capitalized costs are included with property and equipment in the unaudited consolidated balance sheet. Internal-use software is amortized on a straight-line basis over its estimated useful life, generally three to five years, commencing after the software development is substantially complete and the software is ready for its intended use. At each balance sheet date, we evaluate the useful lives of these assets and test for impairment whenever events or changes in circumstances occur that could impact the recoverability of these assets.

Fair Value of Financial Instruments

Ultimate's consolidated financial instruments, consisting of cash and cash equivalents, investments in marketable securities, funds held for customers and the related obligations, accounts receivable, accounts payable, capital lease obligations and other borrowings, approximated fair value as of September 30, 2012 and December 31, 2011.

4. Investments in Marketable Securities and Fair Value of Financial Instruments

We classify our investments in marketable securities with readily determinable fair values as available-for-sale. Available-for-sale securities consist of debt and equity securities not classified as trading securities or as securities to be held to maturity. Unrealized gains and losses on available-for-sale securities are reported as a net amount in accumulated other comprehensive income (loss) in stockholders’ equity until realized. Gains and losses on the sale of available-for-sale securities are determined using the specific identification method. Included in accumulated other comprehensive income (loss) were $2 thousand and $3 thousand of unrealized gains on available-for-sale securities at September 30, 2012 and December 31, 2011, respectively.

The amortized cost, net unrealized gain (loss) and fair value of our investments in marketable available-for-sale securities as of September 30, 2012 and December 31, 2011 are shown below (in thousands):

	September 30, 2012			December 31, 2011		
	Amortized Cost	Net Unrealized	Fair Value	Amortized Cost	Net Unrealized	Fair Value

		Gain (Loss)			Gain (Loss)	
Corporate debentures and bonds	$4,613	$2	$4,615	$2,569	$(3)	$2,566
Commercial paper	2,148	—	2,148	1,799	—	1,799
U.S. Agency bonds	1,000	—	1,000	2,763	1	2,764
U.S. Treasury bills	1,202	2	1,204	1,206	5	1,211
Certificates of deposit	811	—	811	790	—	790
Total investments	$9,774	$4	$9,778	$9,127	$3	$9,130

The amortized cost and fair value of the marketable available-for-sale securities by contractual maturity as of September 30, 2012 are shown below (in thousands):

Table of Contents

	September 30, 2012	
	Amortized Cost	Fair Value
Due in one year or less	$8,706	$8,709
Due after one year	1,068	1,069
Total	$9,774	$9,778

We classify and disclose fair value measurements in one of the following three categories of fair value hierarchy:

Level 1 - Unadjusted quoted prices in active markets that are accessible at the measurement date for identical, unrestricted assets and liabilities.
Level 2 - Quoted prices in markets that are not active or financial instruments for which all significant inputs are observable, either directly or indirectly.
Level 3 - Prices or valuations that require inputs that are both significant to the fair value measurement and unobservable.

A financial instrument's level within the fair value hierarchy is based on the lowest level of any input that is significant to the fair value measurement.

Our assets that are measured by management at fair value on a recurring basis are generally classified within Level 1 or Level 2 of the fair value hierarchy. The types of instruments valued based on quoted market prices in active markets include certificates of deposit. Such instruments are generally classified within Level 1 of the fair value hierarchy. We did not have any transfers into and out of Level 1 or Level 2 during the three or nine months ended September 30, 2012 and the twelve months ended December 31, 2011. No assets or investments were classified as Level 3 as of September 30, 2012 or as of December 31, 2011.

The types of instruments valued by management, based on quoted prices in less active markets, broker or dealer quotations, or alternative pricing sources with reasonable levels of price transparency, include Ultimate's corporate debentures and bonds, commercial paper, U.S. agency bonds and U.S. Treasury bills. Such instruments are generally classified within Level 2 of the fair value hierarchy. Ultimate uses consensus pricing, which is based on multiple pricing sources, to value its fixed income investments. The following table sets forth, by level within the fair value hierarchy, financial assets and liabilities accounted for at fair value as of September 30, 2012 and December 31, 2011 (in thousands):

	September 30, 2012				As of December 31, 2011			
	Total	(Level 1)	(Level 2)	(Level 3)	Total	(Level 1)	(Level 2)	(Level 3)
Corporate debentures and bonds	$4,615	$—	$4,615	$—	$2,566	$—	$2,566	$—
Commercial paper	2,148	—	2,148	—	1,799	—	1,799	—
U.S. Agency bonds	1,000	—	1,000	—	2,764	—	2,764	—
U.S. Treasury bills	1,204	—	1,204	—	1,211	—	1,211	—
Certificates of deposit	811	811	—	—	790	790	—	—
Total	$9,778	$811	$8,967	$—	$9,130	$790	$8,340	$—

Assets and liabilities measured at fair value on a recurring basis were presented in the unaudited condensed consolidated balance sheets as of September 30, 2012 and December 31, 2011 as short-term and long-term investments in marketable securities. There were no financial liabilities accounted for at fair value as of September 30, 2012 and December 31, 2011.

5. Property and Equipment

Property and equipment are stated at cost, net of accumulated depreciation and amortization. Property and equipment are depreciated using the straight-line method over the estimated useful lives of the assets, which range from two to fifteen years. Leasehold improvements and assets under capital leases are amortized over the shorter of the estimated useful life of the asset or the term of the lease, which range from three to fifteen years. Maintenance and repairs are charged to expense when

Table of Contents

incurred; betterments are capitalized. Upon the sale or retirement of assets, the cost, accumulated depreciation and amortization are removed from the accounts and any gain or loss is recognized.

Property and equipment as of September 30, 2012 and December 31, 2011 consist of the following (in thousands):

	September 30, 2012	December 31, 2011
Property and equipment	$ 116,337	$96,920
Less: accumulated depreciation and amortization	(80,790)	(72,434)
Property and equipment, net	$ 35,547	$24,486

6. Prepaid Expenses and Other Current Assets

Prepaid expenses and other current assets as of September 30, 2012 and December 31, 2011 consist of the following (in thousands):

	September 30, 2012	December 31, 2011
Prepaid commissions	$15,559	$13,910
Other prepaid expenses	6,369	3,999
Other current assets	2,761	5,035
Total prepaid expenses and other current assets	$24,689	$22,944

7. Capitalized Software

Capitalized software is amortized using the straight-line method over the estimated useful lives of the assets, which are typically five years. Capitalized software and accumulated amortization of capitalized software as of September 30, 2012 and December 31, 2011 were as follows (in thousands):

	September 30, 2012	December 31, 2011
Capitalized software	$11,342	$11,342
Less: accumulated amortization	(10,590)	(9,577)
Capitalized software, net	$752	$1,765

Amortization of capitalized software was $0.3 million for each of the three months ended September 30, 2012 and September 30, 2011, and $1.0 million for each of the nine months ended September 30, 2012 and September 30, 2011, respectively. Amortization of capitalized software is included with cost of recurring revenues in the unaudited condensed consolidated statements of income.

Expected future amortization for capitalized software at September 30, 2012 is as follows (in thousands):

Year	Amount
2012	$244
2013	508
	$752

Ultimate evaluates the recoverability of capitalized software based on estimated future gross revenues reduced by the estimated costs of completing the products and of performing maintenance and customer support. If Ultimate's gross revenues were to be significantly less than its estimates, the net realizable value of Ultimate's capitalized software intended for sale would be impaired, which could result in the write-off of all or a portion of the unamortized balance of such capitalized software.

Table of Contents

8. Earnings Per Share

Basic earnings per share is computed by dividing income available to common stockholders (the numerator) by the weighted average number of common shares outstanding (the denominator) for the period. The computation of diluted earnings per share is similar to basic earnings per share, except that the denominator is increased to include the number of additional common shares that would have been outstanding if the potentially dilutive common shares had been issued.

The following is a reconciliation of the shares used in the computation of basic and diluted net income per share for the three and nine months ended September 30, 2012 and 2011 (in thousands):

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2012	2011	2012	2011
Basic weighted average shares outstanding	26,852	25,767	26,634	25,733
Effect of dilutive equity instruments	1,643	1,980	1,678	2,057
Dilutive weighted average shares outstanding	28,495	27,747	28,312	27,790
Options to purchase shares of Common Stock and other stock-based awards outstanding which are not included in the calculation of diluted income per share because their impact is anti-dilutive	—	—	11	—

9. Foreign Currency

The financial statements of Ultimate’s foreign subsidiary The Ultimate Software Group of Canada, Inc., (“Ultimate Canada”) have been translated into U.S. dollars. The functional currency of Ultimate Canada is the Canadian dollar. Assets and liabilities are translated into U.S. dollars at period-end exchange rates. Income and expenses are translated at the average exchange rate for the reporting period. The resulting translation adjustments, representing unrealized gains or losses, are included in accumulated other comprehensive income (loss), a component of stockholders’ equity . Realized gains and losses resulting from foreign exchange transactions are included in total operating expenses in the unaudited condensed consolidated statements of income.

For the three and nine months ended September 30, 2012, Ultimate had cumulative unrealized translation gains of $0.4 million and $0.3 million, respectively. For the three and nine months ended September 30, 2011, Ultimate had cumulative unrealized translation losses of $0.3 million and $0.2 million, respectively. Included in accumulated other comprehensive income (loss), as presented in the accompanying unaudited condensed consolidated balance sheets, are $0.2 million of unrealized translation losses at September 30, 2012 and $0.2 million of unrealized translation losses at December 31, 2011.

10. Stock-Based Compensation

Summary of Plans

Our Amended and Restated 2005 Equity and Incentive Plan (the “Plan”) authorizes the grant of options (“Options”) to non-employee directors, officers and employees of Ultimate to purchase shares of Ultimate’s Common Stock ("Common Stock") . The Plan also authorizes the grant to such persons of restricted and non-restricted shares of

Common Stock, stock appreciation rights, stock units and cash performance awards (collectively, together with the Options, the “Awards”).

At the 2012 Annual Meeting of Stockholders, held on May 18, 2012 (the “2012 Annual Meeting”), the stockholders of Ultimate approved the Plan, including an amendment to increase the number of shares of our Common Stock authorized for issuance pursuant to Awards granted under the Plan by 1,500,000 shares. As of September 30, 2012, the aggregate number of shares of Common Stock that were available to be issued under all Awards granted under the Plan was 1,986,849 shares. A complete copy of the Plan is contained in Ultimate's Current Report on Form 8-K that was filed with the SEC on May 21, 2012.

Table of Contents

The following table sets forth the non-cash stock-based compensation expense resulting from stock-based arrangements that was recorded in our unaudited condensed consolidated statements of income for the periods indicated (in thousands):

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2012	2011	2012	2011
Non-cash stock-based compensation expense:				
Cost of recurring revenues	$658	$341	$1,809	$1,020
Cost of services revenues	688	360	1,854	1,107
Sales and marketing	1,886	1,734	5,332	5,244
Research and development	532	403	1,848	1,197
General and administrative	1,136	902	3,274	2,791
Total non-cash stock-based compensation expense	$4,900	$3,740	$14,117	$11,359

Net cash proceeds from the exercise of stock options were $2.3 million and $7.6 million for the three and nine months ended September 30, 2012, respectively, and $1.0 million and $8.4 million for the three and nine months ended September 30, 2011, respectively. There was a $4.2 million and a $7.5 million income tax benefit recognized in additional paid-in capital from the realization of excess stock-based payment deductions during the three and nine months ended September 30, 2012, respectively, and a $2.6 million and $4.3 million income tax benefit recognized in additional paid-in capital from the realization of excess stock-based payment deductions during the three and nine months ended September 30, 2011, respectively.

Stock Option, Restricted Stock and Restricted Stock Unit Activity

There were no stock options granted during the nine months ended September 30, 2012. The following table summarizes stock option activity (for previously granted stock options) for the nine months ended September 30, 2012 (in thousands, except per share amounts):

Stock Options	Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term (in Years)	Aggregate Intrinsic Value
Outstanding at December 31, 2011	2,223	$20.20	4.27	$99,850
Granted	—	$—	—	—
Exercised	(528)	$14.31	—	—
Forfeited or expired	—	$—	—	—
Outstanding at September 30, 2012	1,695	$22.04	3.91	$135,698
Exercisable at September 30, 2012	1,695	$22.04	3.91	$135,698

The aggregate intrinsic value of stock options in the table above represents total pretax intrinsic value (i.e., the difference between the closing price of Ultimate's Common Stock on the last trading day of the reporting period and the exercise price times the number of shares) that would have been received by the option holders had all option holders exercised their options on September 30, 2012. The amount of the aggregate intrinsic value changes, based on the fair value of Ultimate's Common Stock. Total intrinsic value of options exercised was $13.2 million and $34.9 million for the three and nine months ended September 30, 2012, respectively, and $1.5 million and $16.5 million for the three and nine months ended September 30, 2011, respectively. All previously granted stock options were fully vested as of December 31, 2011 and, therefore, there were no options vested during the three and nine months ended

September 30, 2012, respectively. Total fair value of options vested was $0.6 million and $2.2 million for the three and nine months ended September 30, 2011, respectively.

As of September 30, 2012, there were no unrecognized compensation costs related to non-vested stock options expected to be recognized as all previously granted stock options were fully vested as of December 31, 2011.

During the three months ended September 30, 2012 and September 30, 2011, we granted restricted stock awards for 5,351 shares and 5,916 shares, respectively, of Common Stock to non-employee directors. There were 46,400 and 37,617

Table of Contents

restricted stock unit awards granted to employees during the three months ended September 30, 2012 and September 30, 2011, respectively.

During the three months ended September 30, 2012, 1,925 shares of Common Stock previously issued under restricted stock awards became vested and were released to non-employee directors. During the three months ended September 30, 2011, 2,055 shares of Common Stock previously issued under a restricted stock award became vested and were released to non-employee directors.

During the three months ended September 30, 2012, 24,211 shares of Common Stock became payable to officers and employees under restricted stock unit awards that vested and were released during such period. 7,937 of these shares were retained by Ultimate and not issued, in satisfaction of withholding tax requirements applicable to payment of such awards in the amount of $0.7 million, while 16,274 of such shares were issued to the holders of such awards. During the three months ended September 30, 2011, 15,109 shares became payable to officers and employees under restricted stock unit awards that vested and were released during such period. 4,790 of these shares were retained by Ultimate and not issued, in satisfaction of withholding tax requirements applicable to payment of such awards in the amount of $0.2 million, while 10,319 of such shares were issued to the holders of such awards.

The following table summarizes restricted stock award and restricted stock unit activity for the nine months ended September 30, 2012 (in thousands, except per share amounts):

	Restricted Stock Awards		Restricted Stock Unit Awards
	Shares	Weighted Average Grant Date Fair Value	Shares
Outstanding at December 31, 2011	1,045	$31.25	430
Granted	18	$78.58	291
Vested and Released	(22)	$25.08	(196)
Forfeited or expired	(8)	$31.84	(18)
Outstanding at September 30, 2012	1,033	$32.20	507

As of September 30, 2012, $16.4 million of total unrecognized compensation costs related to non-vested restricted stock awards were expected to be recognized over a weighted average period of 1.3 years. As of September 30, 2012, $22.9 million of total unrecognized compensation costs related to non-vested restricted stock unit awards were expected to be recognized over a weighted average period of 1.9 years.

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

The following discussion of the financial condition and results of operations of The Ultimate Software Group, Inc. and subsidiaries ("Ultimate," "we," "us," or "our") should be read in conjunction with the unaudited condensed consolidated financial statements and notes thereto included elsewhere in this Quarterly Report on Form 10-Q (this "Form 10-Q") and in Ultimate's Annual Report on Form 10-K for the fiscal year ended December 31, 2011, filed with the Securities and Exchange Commission (the "SEC") on February 29, 2012 (the "Form 10-K").

Overview

Ultimate is a leading cloud provider of people management solutions.

Ultimate's UltiPro software ("UltiPro") is a comprehensive software as a service ("SaaS")- or cloud-based solution delivered primarily to organizations based in the United States and Canada and designed to deliver the functionality businesses need to manage the complete employment life cycle from recruitment to retirement. UltiPro includes feature sets for talent acquisition and onboarding, human resources ("HR") management and compliance, benefits management and online enrollment, payroll, performance management, salary planning and budgeting for compensation management, succession management, reporting and analytical decision-making tools, and time and attendance. UltiPro has role-based self-service capabilities for executives, managers, administrators, and employees whether they are in or out of the office, including an UltiPro application for use on mobile devices such as the iPhone and iPad.

Our SaaS offering of UltiPro (the "SaaS Offering") provides Web-based access to comprehensive human capital management ("HCM") functionality for organizations that want to simplify delivery and support of their business applications.

Table of Contents

We have found that our SaaS Offering is attractive to companies that want to focus on their core competencies to increase sales and profits. Through the SaaS Offering, we supply and manage the hardware, infrastructure, ongoing maintenance and backup services for our customers. Customer systems are currently managed at three data centers–one located in the Miami, Florida area, one in the Atlanta, Georgia area, and another one in Toronto, Canada. All data centers are owned and operated by independent third parties. We recently signed an agreement for a new data center located in Phoenix, Arizona, which we expect will replace the Miami, Florida data center in the first half of 2013.

UltiPro is marketed as two solution suites, based on company size. UltiPro Enterprise (“Enterprise”) is designed to address the needs of companies with 1,000 or more employees. UltiPro Workplace (“Workplace”) is designed for companies with fewer than 1,000 employees. Both solution suites are delivered exclusively through SaaS. UltiPro Workplace provides medium-sized and smaller companies with nearly all the features that larger Enterprise companies have with UltiPro, plus a bundled services package. Since many companies in this market do not have information technology staff on their premises to help with system issues, UltiPro Workplace is designed to give these customers a high degree of convenience by handling system setup, business rules, and other situations for customers “behind the scenes.” UltiPro is marketed primarily through our Enterprise and Workplace direct sales teams.

In addition to UltiPro’s core HCM functionality, our customers have the option to purchase a number of additional features on a per-employee-per-month (“PEPM”) basis, which are available to enhance the functionality of UltiPro’s core features and which are based on the particular business needs of the customers. These optional UltiPro features currently include (i) the talent management suite of products (recruitment, onboarding, performance management, salary planning and budgeting for compensation management, and employee relations tools for managing disciplinary actions, grievances, and succession management); (ii) benefits enrollment; (iii) time, attendance and scheduling; (iv) time management; (v) payment services (formerly referred to as “tax filing”); (vi) wage attachments; and (vii) other optional features (collectively, “Optional Features”). All Optional Features are priced solely on a subscription basis. Some of the Optional Features are available to both Enterprise and Workplace customers while others are available exclusively to either Enterprise or Workplace customers, and availability is based on the needs of the respective customers, the number of their employees and the complexity of their HCM environment.

Our Partners for Life program, introduced in the second half of 2010, is designed to make it easier for customers to leverage the full scope of UltiPro’s features and reach more users in our customers’ organizations. As part of the Partners for Life program, we changed the pricing method for our services from a time and materials offering to a fixed fee offering, with the expected objective of lowering the total cost of services charged to each customer. The incremental benefit for the Partners for Life program is that we enhance the quality of our customer relationships and encourage increased customer loyalty, as well as an enhanced readiness for the customer to be a reference for us.

The key drivers of our business are (i) growth in recurring revenues; (ii) operating income, excluding primarily non-cash stock-based compensation ("Non-GAAP Operating Income"); and (iii) retention of our customers once our solutions are sold (“Customer Retention”). For the three months ended September 30, 2012, our (i) recurring revenues grew by 23%, compared with the same period in 2011 and (ii) Non-GAAP Operating Income was $14.2 million, or 17.2% of total revenues, as compared with $8.6 million, or 12.7% of total revenues, for the same period last year. For the nine months ended September 30, 2012, our (i) recurring revenues grew by 23%, compared with the same period in 2011, and (ii) Non-GAAP Operating Income was $30.9 million, or 12.9% of total revenues, as compared with $20.1 million, or 10.2% of total revenues, for the same period last year. As of September 30, 2012, our Customer Retention exceeded 96%, on a trailing twelve-month basis. See “Non-GAAP Financial Measures” below.

Our ability to achieve significant revenue growth in the future will depend upon the success of our direct sales force and our ability to adapt our sales efforts to address the evolving markets for our products and services. We provide our sales personnel with comprehensive and continuing training with respect to technology and market place developments. Aside from sales commissions, we also provide various incentives to encourage our sales representatives, including stock-based compensation awards based upon performance.

The HCM market is intensely competitive. We address competitive pressures through improvements and enhancements to our products and services, the development of additional features of UltiPro and a comprehensive marketing team and process that distinguishes Ultimate and its products from the competition. Our focus on customer service, which enables us to maintain a high Customer Retention rate, also helps us address competitive pressures.

As our business has grown, we have become increasingly subject to the risks arising from adverse changes in domestic and global economic conditions. If general economic conditions were to deteriorate further, we may experience delays in our sales cycles, increased pressure from prospective customers to offer discounts and increased pressure from existing customers

Table of Contents

to renew expiring recurring revenue agreements for lower amounts. We address continuing economic pressures by, among other things, efforts to control growth of our operating expenses through the monitoring of controllable costs and vendor negotiations.

Ultimate has two primary revenue sources: recurring revenues and services revenues. Subscription revenues from our SaaS Offering and customer support and maintenance revenues are the primary components of recurring revenues. The majority of services revenues are derived from implementation services. Subsequent to the discontinuation of selling perpetual licenses of UltiPro to new customers, which occurred in 2009, we sell licenses to existing license customers but only in relation to the customer's employee growth or for Optional Features if the customer already has a perpetual license for the on-site UltiPro solutions. As perpetual license agreements were sold in the past, annual maintenance contracts (priced as a percentage of the related license fee) accompanied those agreements. Maintenance contracts typically have a one-year term with annual renewal periods thereafter.

As SaaS units are sold, the recurring revenue backlog associated with the SaaS Offering grows, enhancing the predictability of future revenue streams. SaaS revenues include ongoing monthly subscription fees, priced on a PEPM basis. Revenue recognition for the SaaS Offering is triggered when the customer processes its first payroll using UltiPro (or goes "Live").

Critical Accounting Estimates

The preparation of financial statements in conformity with U.S. generally accepted accounting principles ("GAAP") requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Ultimate's critical accounting estimates, as discussed in "Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations," included in the Form 10-K, have not significantly changed, except as disclosed below:

Computer Software Development Costs

Certain computer software development costs are capitalized in the accompanying unaudited consolidated balance sheets. We follow different accounting guidance rules for software capitalization purposes, depending on whether the underlying software is for external use or internal use.

Computer software development costs related to software developed for external use falls under the accounting guidance of Accounting Standards Codification ("ASC") Topic 985-20, Costs of Software to Be Sold, Leased, or Marketed, in which capitalization begins upon the establishment of technological feasibility. For software costs that are capitalized in accordance with ASC Topic 985-20, technological feasibility is typically established upon completion of a working model. Capitalization ends and amortization begins when the related developed software is ready for general release to our customers. Amortization periods for software capitalized under this subtopic are generally five years. We have begun amortization for all capitalized software that falls under this guidance. Capitalized software falling under ASC Topic 985-20 is related to our former licensed products, which is presented in the unaudited consolidated balance sheets as capitalized software. There were no research and development expenses capitalized under ASC Topic 985-20 during the three and nine months ended September 30, 2012 and September 30, 2011. Annual amortization is based on the greater of the amount computed using (a) the ratio that current gross revenues for the related product bears to the total of current and anticipated future gross revenues for that product or (b) the straight-line method over the remaining estimated economic life of the product including the period being reported on. Capitalized software is amortized using the straight-line method over the estimated useful lives of the assets, which is typically five years. Ultimate evaluates the recoverability of capitalized software based on estimated future gross revenues reduced by the estimated costs of completing the products and of performing maintenance and customer support. If Ultimate's gross revenues were to be significantly less than its estimates, the net realizable value of Ultimate's capitalized software would be impaired, which could result in the write-off of all or a portion of the unamortized balance of such capitalized software.

Computer software development costs related to software developed for internal use falls under the accounting guidance of ASC Topic 350-40, Intangibles Goodwill and Other–Internal Use Software, in which computer software costs are expensed as incurred during the preliminary project stage and capitalization begins in the application development stage once the capitalization criteria are met. Costs associated with post implementation activities are expensed as incurred. Costs capitalized during the application development stage include external direct costs of materials and services consumed in developing or obtaining internal-use software and payroll and payroll-related costs for employees who are directly associated with and who devote time to the internal-use computer software. In addition to capitalizing costs for software (which are used by Ultimate in its general operations, for internal purposes) , we also capitalize costs under ASC Topic 350-40 for certain

Table of Contents

software development projects related to our suite of products sold to our customers exclusively on a subscription basis under our SaaS Offering of UltiPro (the "SaaS Offering"). During the three and nine months ended September 30, 2012, we capitalized $2.6 million of computer software development costs related to a development project to be sold in the future as a SaaS product only. There were no such costs capitalized in the three and nine months ended September 30, 2011. These capitalized costs are included with property and equipment in the unaudited consolidated balance sheet. Internal-use software is amortized on a straight-line basis over its estimated useful life, generally three to five years, commencing after the software development is substantially complete and the software is ready for its intended use. At each balance sheet date, we evaluate the useful lives of these assets and test for impairment whenever events or changes in circumstances occur that could impact the recoverability of these assets.

Fair Value of Financial Instruments

Ultimate's consolidated financial instruments, consisting of cash and cash equivalents, investments in marketable securities, funds held for customers and the related obligations, accounts receivable, accounts payable, capital lease obligations and other borrowings, approximated fair value as of September 30, 2012 and December 31, 2011.

Results of Operations

The following table sets forth the unaudited condensed consolidated statements of income data of Ultimate, as a percentage of total revenues, for the periods indicated:

	For the Three Months Ended September 30,				For the Nine Months Ended September 30,			
	2012		2011		2012		2011	
Revenues:								
Recurring	81.7	%	80.7	%	80.4	%	79.7	%
Services	18.3		18.9		19.2		19.5	
License	—		0.4		0.4		0.8	
Total revenues	100.0		100.0		100.0		100.0	
Cost of revenues:								
Recurring	23.5		24.4		24.0		23.8	
Services	19.9		19.3		19.9		19.9	
License	—		0.1		0.1		0.2	
Total cost of revenues	43.4		43.8		44.0		43.9	
Gross Profit	56.6		56.2		56.0		56.1	
Operating expenses:								
Sales and marketing	20.9		22.1		22.2		24.3	
Research and development	17.0		19.6		19.1		19.1	
General and administrative	7.5		7.4		7.7		8.3	
Total operating expenses	45.4		49.1		49.0		51.7	
Operating income	11.2		7.1		7.0		4.4	
Other (expense) income:								
Interest expense and other	(0.2	)	(0.1	)	(0.1	)	(0.2	)
Other income, net	0.1		—		—		—	
Total other expense, net	(0.1	)	(0.1	)	(0.1	)	(0.2	)
Income before income taxes	11.1		7.0		6.9		4.2	
Provision for income taxes	(5.4	)	(5.4	)	(3.4	)	(3.0	)
Net income	5.7	%	1.6	%	3.5	%	1.2	%

15

Table of Contents

The following table sets forth the non-cash stock-based compensation expense resulting from the stock-based arrangements (excluding the income tax effect) and the amortization of acquired intangibles that are recorded in our unaudited condensed consolidated statements of income for the periods indicated (in thousands):

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2012	2011	2012	2011
Non-cash stock-based compensation expense:				
Cost of recurring revenues	$658	$341	$1,809	$1,020
Cost of services revenues	688	360	1,854	1,107
Sales and marketing	1,886	1,734	5,332	5,244
Research and development	532	403	1,848	1,197
General and administrative	1,136	902	3,274	2,791
Total non-cash stock-based compensation expense	$4,900	$3,740	$14,117	$11,359
Amortization of acquired intangibles:				
General and administrative	$—	$27	$—	$83

Revenues

Our revenues are primarily derived from recurring revenues and services revenues.

Total revenues increased 22.0% to $82.6 million for the three months ended September 30, 2012 from $67.8 million for the three months ended September 30, 2011, and 22.2% to $240.1 million for the nine months ended September 30, 2012 from $196.5 million for the nine months ended September 30, 2011.

Recurring revenues, consisting of subscription revenues from our SaaS Offering and customer support and maintenance revenues, increased 23.4% to $67.5 million for the three months ended September 30, 2012 from $54.7 million for the three months ended September 30, 2011 and 23.2% to $193.0 million for the nine months ended September 30, 2012 from $156.6 million for the nine months ended September 30, 2011. The increase for the three and nine months ended September 30, 2012 was primarily due to increased subscription revenues from our SaaS Offering, partially offset by a decrease in our customer support and maintenance revenues.

a) Subscription revenues from our SaaS Offering increased 27.3% for the three months ended September 30, 2012 and 28.0% for the nine months ended September 30, 2012, both in comparison to the same periods in 2011. This increase was based on the revenue impact of incremental units sold that have gone Live since September 30, 2011, including the UltiPro core product and, to a lesser extent, Optional Features of UltiPro. Recognition of recurring subscription revenues from our SaaS Offering begins when the related customer goes Live.

b) Maintenance revenues decreased 3.1% for the three months ended September 30, 2012, and by 4.7% for the nine months ended September 30, 2012, both in comparison to the same periods in 2011. The decreases resulted from the transition of certain customers who were formerly using UltiPro in connection with the prior purchase of a perpetual license to using UltiPro under our SaaS Offering, combined with the impact of attrition in the ordinary course of business, partially offset by price increases. Maintenance revenues are recognized on a monthly recurring basis as the maintenance contracts renew annually.

Services revenues increased 18.2% to $15.1 million for the three months ended September 30, 2012 from $12.8 million for the three months ended September 30, 2011, and 20.6% to $46.2 million for the nine months ended September 30, 2012 from $38.3 million for the nine months ended September 30, 2011. The increases in services revenues for the three- and nine-month periods were primarily due to additional implementation consulting revenues which were attributable to a combination of more billable consultants and the increased utilization of seasoned consultants. In addition, there was a continued shift toward more implementation consulting revenues from fixed fee arrangements and less implementation consulting revenues from time and materials arrangements, principally as a result of the Partners for Life program. The Partners for Life program changed the method by which we charge customers for our services that are delivered primarily over the period leading up to the point the customer goes Live (the “Time to Live Period”). As new sales are generated, we now charge a fixed fee for services based on the number of the customer’s employees, as compared to our former billing method for new sales, which included charging customers on a time and materials basis as these services were provided. The Partners for

Table of Contents

Life program was designed to lower the total cost of services charged to each customer primarily over the Time to Live Period for UltiPro and/or Optional Features. Recognition of implementation consulting revenues related to fixed fee arrangements under the Partners for Life program is based on the percentage of completion method associated with implementation milestones achieved.

Cost of Revenues

Cost of revenues primarily consists of the costs of recurring and services revenues. Cost of recurring revenues primarily consists of costs to provide maintenance and technical support to Ultimate's customers, the cost of providing periodic updates and the cost of recurring subscription revenues, including hosting data center costs and amortization of capitalized software. Cost of services revenues primarily consists of costs to provide implementation services and training to Ultimate's customers and, to a lesser extent, costs related to sales of payroll-related forms and Form W-2 services, as well as costs associated with certain client reimbursable out-of-pocket expenses.

Total cost of revenues increased 20.9% to $35.8 million for the three months ended September 30, 2012, from $29.7 million for the three months ended September 30, 2011. Total cost of revenues increased 22.7% to $105.8 million for the nine months ended September 30, 2012, from $86.2 million for the nine months ended September 30, 2011.

Cost of recurring revenues increased 17.4% to $19.4 million for the three months ended September 30, 2012 from $16.5 million for the three months ended September 30, 2011, and 23.5% to $57.7 million for the nine months ended September 30, 2012 from $46.8 million for the nine months ended September 30, 2011. The increases in the cost of recurring revenues for the three- and nine-month periods were primarily due to increases in both SaaS costs and customer support and maintenance costs, as described below:

i) The increase in SaaS costs was principally as a result of the growth in SaaS operations and increased sales, including increased labor costs, increased hosting data center costs and, to a lesser extent, costs related to our payment services (as we continue to grow that business).

ii) The increase in customer support and maintenance costs was primarily due to higher labor costs commensurate with the growth in the number of customers serviced.

Cost of services revenues increased 25.9% to $16.5 million for the three months ended September 30, 2012 from $13.1 million for the three months ended September 30, 2011, and 22.3% to $47.8 million for the nine months ended September 30, 2012 from $39.1 million for the nine months ended September 30, 2011. The increases in cost of services revenues for the three- and nine-month periods were primarily due to an increase in the cost of implementation. The increased cost of implementation was primarily from higher labor and related costs (particularly in association with increased number of billable consultants) and increased costs of third-party consulting partners.

Sales and Marketing

Sales and marketing expenses consist primarily of salaries and benefits, sales commissions, travel and promotional expenses, and facility and communication costs for direct sales offices, as well as advertising and marketing costs. Sales and marketing expenses increased 14.8% to $17.2 million for the three months ended September 30, 2012 from $15.0 million for the three months ended September 30, 2011 and by 11.9% to $53.3 million for the nine months ended September 30, 2012 from $47.6 million for the nine months ended September 30, 2011. The increases in sales and marketing expenses for the three- and nine-month periods were primarily due to increased labor and related costs (including higher sales commissions related to increased live units for SaaS sales), and, to a lesser extent, higher advertising and marketing expenses. Commissions on SaaS sales are amortized over the initial contract term (typically 24 months) commencing on the Live date, which corresponds to the related SaaS subscription revenue recognition.

Research and Development

Research and development expenses consist primarily of software development personnel costs. Research and development expenses increased 6.1% to $14.1 million for the three months ended September 30, 2012 from $13.3 million for the three months ended September 30, 2011 and by 21.7% to $45.8 million for the nine months ended September 30, 2012 from $37.6 million for the nine months ended September 30, 2011. The increases in research and development expenses for the three- and nine-month periods were principally due to higher labor and related costs associated with the ongoing development of UltiPro and Optional Features, including the impact of increased personnel costs (predominantly from additional headcount), net of capitalized labor costs, and increased third-party consulting costs. During the three and nine months ended September

Table of Contents

30, 2012, we capitalized a total of $2.6 million for internal-use software costs for a development project that will be offered exclusively as SaaS when it is eventually ready for its intended use. The majority of these capitalized costs were direct labor costs associated with the development project. There were no capitalized labor costs for the three and nine months ended September 30, 2011.

General and Administrative

General and administrative expenses consist primarily of salaries and benefits of executive, administrative and financial personnel, as well as external professional fees and the provision for doubtful accounts. General and administrative expenses increased 24.6% to $6.2 million for the three months ended September 30, 2012 from $5.0 million for the three months ended September 30, 2011. General and administrative expenses increased 13.0% to $18.5 million for the nine months ended September 30, 2012 from $16.4 million for the nine months ended September 30, 2011. The increases in general and administrative expenses for the three- and nine-month periods were primarily due to higher labor and related costs, partially offset by a lower provision for doubtful accounts.

Income Taxes

Income taxes for the three months ended September 30, 2012 and September 30, 2011 included a consolidated provision of $4.5 million and $3.7 million, respectively. The effective income tax rate for the three months ended September 30, 2012 and September 30, 2011 was 49.1% and 77.4%, respectively. Income taxes for the nine months ended September 30, 2012 and September 30, 2011 included a consolidated provision of $8.2 million and $6.1 million, respectively. The effective income tax rate for the nine months ended September 30, 2012 and September 30, 2011 was 49.5% and 72.4%, respectively. The decrease in the effective income tax rate for the three and nine months ended September 30, 2012 was principally due to a benefit attributable to a decrease in nondeductible expenses, primarily related to compensation, and a lower ratio of expected nondeductible expenses to pre-tax income.

At December 31, 2011, we had approximately $113.0 million of net operating loss carryforwards for Federal income tax reporting purposes available to offset future taxable income. The $113.0 million was attributable to deductions from the exercise of non-qualified employee, and non-employee director, stock options and the vesting of restricted stock units and restricted stock awards, the tax benefit of which will primarily be credited to paid-in-capital and deferred tax assets when realized. As a result, the tax benefit associated with stock-based compensation is included in net operating loss carryforwards but not reflected in deferred tax assets. The carryforwards expire from 2012 through 2031. Utilization of such net operating loss carryforwards may be limited as a result of cumulative ownership changes in Ultimate’s equity instruments. As of December 31, 2011, we did not have any net operating loss carryforwards for foreign income tax reporting purposes available to offset future taxable income. The Company's U.S. Federal income tax return for the year ended December 31, 2010 is currently under review by the Internal Revenue Service.

We recognized $21.0 million of deferred tax assets, net of deferred tax liabilities, as of September 30, 2012. If estimates of taxable income are decreased, a valuation allowance may need to be provided for some or all deferred tax assets, which will cause an increase in income tax expense. Management continues to apply the exception to the comprehensive recognition of deferred income taxes to the undistributed earnings of our foreign subsidiary, The Ultimate Software Group of Canada, Inc. (“Ultimate Canada”). Accordingly, deferred income taxes were not recognized on the cumulative undistributed earnings of Ultimate Canada, and were not deemed material.

Liquidity and Capital Resources

In recent years, Ultimate has funded operations from cash flows generated from operations.

As of September 30, 2012, we had $82.9 million in cash, cash equivalents and total investments in marketable securities, reflecting a net increase of $27.6 million since December 31, 2011. This $27.6 million increase was primarily due to cash provided by operations of $32.3 million and proceeds from the issuance of Common Stock from employee and non-employee director stock option exercises of $7.6 million, partially offset by cash purchases of property and equipment (including principal payments on financed equipment) of $14.7 million and cash used to settle the employee tax withholding liability for vesting of restricted stock awards and restricted stock units of $5.1 million.

Net cash provided by operating activities was $32.3 million for the nine months ended September 30, 2012, as compared with $23.6 million for the nine months ended September 30, 2011. This $8.7 million increase was primarily due to an increase in cash operating results of $8.4 million, an increase in accrued expenses of $3.3 million associated with expenses that will be primarily paid in the near term, a decrease in prepaid expenses and other current assets of $2.2 million principally

Table of Contents

related to the amortization of prepaid expenses, partially offset by an increase in accounts receivable, net of the change to deferred revenue, of $4.5 million and higher vendor payments of $1.8 million.

Net cash used in investing activities was $38.4 million for the nine months ended September 30, 2012, as compared with $39.2 million for the nine months ended September 30, 2011. The decrease of $0.8 million was primarily attributable to a decrease in funds received from and held on behalf of Ultimate's customers using the UltiPro Payment Services offering ("UltiPro Payment Services") of $2.3 million, partially offset by an increase in cash purchases of property and equipment of $1.5 million. During the three and nine months ended September 30, 2012, we capitalized software development costs related to a SaaS development project, totaling $2.6 million, which was classified as property and equipment in accordance with the applicable accounting guidance. With the exception of the stock-based compensation that was capitalized of $0.2 million, the capitalized software costs were paid in cash, since the majority of these costs were direct labor costs.

Net cash provided by financing activities was $32.8 million for the nine months ended September 30, 2012, as compared with $17.1 million for the nine months ended September 30, 2011. The $15.7 million increase was primarily related to an increase of $17.3 million attributable to a decreased amount paid for purchases of Common Stock under our stock repurchase plan and a $3.2 million increase in excess tax benefits from stock option exercises and a decrease of $1.2 million in cash used to settle employee tax withholding liability for vesting of restricted stock awards and restricted stock units, partially offset by a decrease of $2.3 million in UltiPro Payment Services, and a $0.9 million decrease in proceeds from the issuance of Common Stock from stock option exercises.

Days sales outstanding, calculated on a trailing three-month basis, as of September 30, 2012 and September 30, 2011, were 64 days and 63 days, respectively.

Deferred revenues were $85.1 million at September 30, 2012, as compared with $86.6 million at December 31, 2011. The decrease of $1.5 million in deferred revenues was primarily due to decreased deferred maintenance revenues, partially offset by increased deferred SaaS revenues and, to a lesser extent, increased deferred services revenues. The majority of the total balance in deferred revenues is related to future recurring revenues, including deferred revenues related to SaaS.

During the nine months ended September 30, 2012, we purchased perpetual licenses with third-party vendors totaling $6.5 million, payable over a three-year period, of which payments totaling $2.5 million were made.

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

We did not have any material commitments for capital expenditures as of September 30, 2012.

Off-Balance Sheet Arrangements

We do not, and as of September 30, 2012 we did not, have any off-balance sheet arrangements (as that term is defined in applicable SEC rules) that are reasonably likely to have a current or future material effect on our financial condition, results of operations, liquidity, capital expenditures or capital resources.

Quarterly Fluctuations

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

Table of Contents

Forward-Looking Statements

The foregoing Management's Discussion and Analysis of Financial Condition and Results of Operations and the following Quantitative and Qualitative Disclosures about Market Risk contain certain forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended (the "Exchange Act"). These forward-looking statements represent our expectations or beliefs, including, but not limited to, our expectations concerning our operations and financial performance and condition. Words such as "anticipates," "expects," "intends," "plans," "believes," "seeks," "estimates," and si expressions are intended to identify such forward-looking statements. These forward-looking statements are not guarantees of future performance and are subject to certain risks and uncertainties that are difficult to predict. Ultimate's actual results could differ materially from those contained in the forward-looking statements due to risks and uncertainties associated with fluctuations in our quarterly operating results, concentration of our product offerings, development risks involved with new products and technologies, competition, our contractual relationships with third parties, contract renewals with business partners, compliance by our customers with the terms of their contracts with us, and other factors disclosed in Ultimate's filings with the SEC. Other factors that may cause such differences include, but are not limited to, those discussed in this Form 10-Q and the Form 10-K, including the risk factors set forth in Part I, Item 1A of the Form 10-K. Ultimate undertakes no obligation to publicly update or revise any forward-looking statements, whether as a result of new information, future events or otherwise.

Non-GAAP Financial Measures

Item 10 (e) of Regulation S-K, "Use of Non-GAAP Financial Measures in Commission Filings," defines and prescribes the use of non-GAAP financial information. Our measure of Non-GAAP Operating Income, which excludes non-cash stock-based compensation and amortization of acquired intangibles, meets the definition of a non-GAAP financial measure.

Ultimate believes that this non-GAAP measure of financial results provides useful information to management and investors regarding certain financial and business trends relating to Ultimate's financial condition and results of operations. Ultimate's management uses this non-GAAP result to compare Ultimate's performance to that of prior periods for trend analyses, for purposes of determining executive incentive compensation, and for budget and planning purposes. This measure is used in monthly financial reports prepared for management and in quarterly financial reports presented to Ultimate's Board of Directors. This measure may be different from non-GAAP financial measures used by other companies.

This non-GAAP measure should not be considered in isolation or as an alternative to such measures determined in accordance with generally accepted accounting principles in the United States (GAAP). The principal limitation of this non-GAAP financial measure is that it excludes significant expenses that are required by GAAP to be recorded. In addition, it is subject to inherent limitations as it reflects the exercise of judgment by management about which expenses are excluded from the non-GAAP financial measure.

To compensate for these limitations, Ultimate presents its non-GAAP financial measure in connection with its GAAP result. Ultimate strongly urges investors and potential investors in Ultimate's securities to review the reconciliation of its non-GAAP financial measure to the comparable GAAP financial measure that is included in the table below and not to rely on any single financial measure to evaluate its business.

We exclude the following items from the non-GAAP financial measure, Non-GAAP Operating Income, as appropriate:

Stock-based compensation expense. Ultimate's non-GAAP financial measures exclude stock-based compensation expense, which consists of expenses for stock options and stock and stock unit awards recorded in accordance with Accounting Standards Codification 718, “Compensation - Stock Compensation.” For the three and nine months ended September 30, 2012, stock-based compensation expense was $4.9 million and $14.1 million, respectively, on a pre-tax basis. For the three and nine months ended September 30, 2011, stock-based compensation expense was $3.7 million and $11.4 million, respectively, on a pre-tax basis. Stock-based compensation expense is excluded from the non-GAAP financial measures because it is a non-cash expense that Ultimate does not consider part of ongoing operations when assessing its financial performance. Ultimate believes that such exclusion facilitates the comparison of results of ongoing operations for current and future periods with such results from past periods. For GAAP net income periods, non-GAAP reconciliations are calculated on a diluted weighted average share basis.

Amortization of acquired intangible assets. In accordance with GAAP, operating expenses include amortization of acquired intangible assets over the estimated useful lives of such assets. There was no amortization of acquired intangible

Table of Contents

assets for the three and nine months ended September 30, 2012. For the three and nine months ended September 30, 2011, the amortization of acquired intangible assets was $27 thousand and $83 thousand, respectively. Amortization of acquired intangible assets is excluded from Ultimate's non-GAAP financial measures because it is a non-cash expense that Ultimate does not consider part of ongoing operations when assessing its financial performance. Ultimate believes that such exclusion facilitates comparisons to its historical operating results and to the results of other companies in the same industry, which have their own unique acquisition histories.

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2012	2011	2012	2011
Non-GAAP operating income reconciliation:				
Operating income	$9,281	$4,842	$16,761	$8,651
Operating income, as a % of total revenues	11.2 %	7.1 %	7.0 %	4.4 %
Add back:				
Non-cash stock-based compensation expense	4,900	3,740	14,117	11,359
Non-cash amortization of acquired intangible assets	–	27	–	83
Non-GAAP operating income	$14,181	$8,609	$30,878	$20,093
Non-GAAP operating income, as a % of total revenues	17.2 %	12.7 %	12.9 %	10.2 %

ITEM 3. Quantitative and Qualitative Disclosures About Market Risk

In the ordinary course of Ultimate’s operations, we are exposed to certain market risks, primarily interest rate risk and foreign currency risk. Risks that are either non-financial or non-quantifiable, such as political, economic, tax, or regulatory risks, are not included in the following assessment of our market risks.

Interest Rate Risk. Ultimate is subject to financial market risks, including changes in interest rates which influence the valuations of our fixed income investment portfolio. Changes in interest rates could also impact Ultimate’s anticipated interest income from interest-bearing cash accounts, or cash equivalents and investments in marketable securities. We manage financial market risks, including interest rate risks, in accordance with our investment guideline objectives, including:

- Maximum safety of principal;
- Maintenance of appropriate liquidity for regular cash needs;
- Maximum yields in relationship to guidelines and market conditions;
- Diversification of risks; and
- Fiduciary control of all investments.

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

Cash equivalents consist of money market accounts with original maturities of less than three months. Short-term investments include obligations of U.S. government agencies and corporate debt securities. Corporate debt securities include commercial paper which, according to Ultimate’s investment guidelines, must carry minimum short-term ratings of P-1 by Moody’s Investor Service, Inc. (“Moody’s”) and A-1 by Standard & Poor’s Ratings Service, a Division of The McGraw-Hill Companies, Inc. (“S&P”). Other corporate debt obligations must carry a minimum rating of A-2 by Moody’s or A by S&P. Asset-backed securities must carry a minimum AAA rating by Moody’s and S&P with a maximum average life of two years at the time of purchase.

As of September 30, 2012, total investments in available-for-sale marketable securities were $9.8 million.

Table of Contents

As of September 30, 2012, virtually all of the investments in Ultimate's portfolio were at fixed rates (with a weighted average interest rate of 0.3% per annum).

To illustrate the potential impact of changes in interest rates, Ultimate has performed an analysis based on its September 30, 2012 unaudited condensed consolidated balance sheet and assuming no changes in its investments. Under this analysis, an immediate and sustained 100 basis point increase in the various base rates would result in a decrease in the fair value of Ultimate's total portfolio of approximately $44 thousand over the next 12 months. An immediate and sustained 100 basis point decrease in the various base rates would result in an increase in the fair value of Ultimate's total portfolio of approximately $44 thousand over the next 12 months.

Foreign Currency Risk. Ultimate has foreign currency risks related to its revenue and operating expenses denominated in currencies other than the U.S. dollar. Management does not believe movements in the foreign currencies in which Ultimate transacts business will significantly affect future net income.

ITEM 4. Controls and Procedures

(a) Evaluation of disclosure controls and procedures. Ultimate carried out an evaluation, under the supervision and with the participation of Ultimate's management, including the Chief Executive Officer (the "CEO") and the Chief Financial Officer (the "CFO"), of the effectiveness of the design and operation of Ultimate's disclosure controls and procedures as of the end of the period covered by this Form 10-Q pursuant to Rule 13a-15(b) under the Exchange Act . Based on that evaluation, Ultimate's management, including the CEO and CFO, concluded that, as of September 30, 2012, Ultimate's disclosure controls and procedures were effective to provide reasonable assurance that information required to be disclosed in Ultimate's Exchange Act reports is recorded, processed, summarized and reported within the time periods specified by the SEC's rules and forms and is accumulated and communicated to management, including the CEO and CFO, as appropriate to allow timely decisions regarding required disclosure. Ultimate's disclosure controls and procedures were designed to provide reasonable assurance as to the achievement of these objectives. It should be noted that the design of any system of controls is based in part upon certain assumptions about the likelihood of future events and thus has inherent limitations. Therefore, even those systems determined to be effective can only provide reasonable assurance as to the achievement of their objectives.

(b) Changes in internal control over financial reporting. There have been no changes during the quarter ended September 30, 2012 in Ultimate's internal control over financial reporting that have materially affected, or are reasonably likely to materially affect, Ultimate's internal control over financial reporting.

PART II – OTHER INFORMATION
ITEM 1A. Risk Factors

The risk factors associated with Ultimate's business, as disclosed in Part I, Item 1A, "Risk Factors," in the Form 10-K, have not significantly changed.

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

(c) Purchases of Equity Securities by the Issuer. As of September 30, 2012, Ultimate had purchased 3,941,813 shares of Ultimate's issued and outstanding Common Stock under our stock repurchase plan, with 1,058,187 shares being available for repurchase in the future. There were no repurchases of shares of Ultimate's issued and outstanding Common Stock under the stock repurchase plan during the three months ended September 30, 2012.

ITEM 6. Exhibits

22

Table of Contents

Number	Description
10.1	Commercial lease between TCS-CB LLC, ("Landlord") and Ultimate, dated July 25, 2012 *
10.2	License and Master Services Agreement between IO Phoenix One, LLC and Ultimate, dated February 27, 2012, as amended *
31.1	Certification Pursuant to Rule 13a-14(a) and Rule 15d-14(a) of the Securities Exchange Act of 1934, as amended *
31.2	Certification Pursuant to Rule 13a-14(a) and Rule 15d-14(a) of the Securities Exchange Act of 1934, as amended *
32.1	Certification Pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, as amended *
32.2	Certification Pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, as amended *
101.1	Interactive Data Files pursuant to Rule 405 of Regulation S-T: (i) Unaudited Condensed Consolidated Balance Sheets as of September 30, 2012 and December 31, 2011, (ii) Unaudited Condensed Consolidated Statements of Income for the Three and Nine Months Ended September 30, 2012 and September 30, 2011, (iii) Unaudited Condensed Consolidated Statements of Comprehensive Income for the Three and Nine Months Ended September 30, 2012 and September 30, 2011, (iv) Unaudited Condensed Consolidated Statements of Cash Flows for the Nine Months Ended September 30, 2012 and September 30, 2011 and (v) Notes to Unaudited Condensed Consolidated Financial Statements

* Filed herewith.

Table of Contents

Signatures

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

The Ultimate Software Group, Inc.

Date: November 9, 2012

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