

DATAWATCH CORP  
Form 10-Q  
May 14, 2010

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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549

FORM 10-Q

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

For the Quarterly Period Ended March 31, 2010

OR

o 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: 000-19960

DATAWATCH CORPORATION  
(Exact name of registrant as specified in its charter)

DELAWARE  
(State or Other Jurisdiction of  
Incorporation or Organization)

02-0405716  
(I.R.S. Employer  
Identification No.)

271 MILL ROAD  
QUORUM OFFICE PARK  
CHELMSFORD, MASSACHUSETTS 01824  
(978) 441-2200  
(Address and telephone number of principal executive office)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes ☒ No ☐

Indicate by check mark whether the registrant 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 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

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a smaller reporting company. See definition 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 Exchange Act Rule 12b-2).

Yes ☐ No ☒

The number of shares of the registrant’s common stock, \$.01 par value, outstanding as of May 10, 2010 was 5,943,159.

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DATAWATCH CORPORATION  
QUARTERLY REPORT ON FORM 10-Q  
For the Quarterly Period Ended March 31, 2010

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## PART I. FINANCIAL INFORMATION

## Item 1: FINANCIAL STATEMENTS

DATAWATCH CORPORATION  
CONDENSED CONSOLIDATED BALANCE SHEETS (UNAUDITED)  
(In thousands, except share and per share amounts)

	March 31, 2010	September 30, 2009
<b>ASSETS</b>		
<b>CURRENT ASSETS:</b>		
Cash and equivalents	\$6,337	\$ 5,649
Accounts receivable, less allowances for doubtful accounts and sales returns of \$388,000 at March 31, 2010 and \$215,000 at September 30, 2009	2,409	2,968
Inventories	61	65
Prepaid expenses	459	340
Total current assets	9,266	9,022
Property and equipment, net	413	498
Intangible assets, net	1,875	2,397
Restricted cash	89	107
Other long-term assets	20	19
Total assets	\$ 11,663	\$ 12,043
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
<b>CURRENT LIABILITIES:</b>		
Accounts payable	\$757	\$ 761
Accrued expenses	1,784	1,915
Deferred revenue	3,822	3,719
Total current liabilities	6,363	6,395
<b>LONG-TERM LIABILITIES:</b>		
Deferred rent	19	55
Deferred revenue - long-term	221	302
Other liabilities	137	125
Total long-term liabilities	377	482
<b>COMMITMENTS AND CONTINGENCIES</b>		
<b>SHAREHOLDERS' EQUITY:</b>		
Common stock, par value \$.01; 20,000,000 shares authorized; issued, 5,957,405 shares and 5,940,085 shares, respectively; outstanding, 5,943,159 shares and 5,925,839 shares, respectively	60	59
Additional paid-in capital	23,736	23,634
Accumulated deficit	(17,667)	(17,370)
Accumulated other comprehensive loss	(1,066)	(1,017)
	5,063	5,306

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Less treasury stock, at cost, 14,246 shares	(140	)	(140	)
Total shareholders' equity	4,923		5,166	
 Total liabilities and shareholders' equity	 \$ 11,663		 \$ 12,043	

See notes to condensed consolidated financial statements.

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DATAWATCH CORPORATION  
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS (UNAUDITED)  
(In thousands, except per share amounts)

	Three Months Ended March 31,		Six Months Ended March 31,	
	2010	2009	2010	2009
REVENUE:				
Software licenses and subscriptions	\$ 2,593	\$ 2,973	\$ 4,759	\$ 5,813
Maintenance and services	1,978	2,119	4,047	4,481
Total revenue	4,571	5,092	8,806	10,294
COSTS AND EXPENSES:				
Cost of software licenses and subscriptions	648	531	1,222	1,061
Cost of maintenance and services	747	834	1,506	1,707
Sales and marketing	1,588	1,854	3,135	3,515
Engineering and product development	710	585	1,419	1,298
General and administrative	970	1,018	1,806	2,184
Impairment of goodwill and other intangible assets	-	6,401	-	6,401
Total costs and expenses	4,663	11,223	9,088	16,166
LOSS FROM OPERATIONS	(92 )	(6,131 )	(282 )	(5,872 )
Interest income and other income (expense), net	1	(7 )	(1 )	163
LOSS BEFORE INCOME TAXES	(91 )	(6,138 )	(283 )	(5,709 )
Provision (benefit) for income taxes	6	(284 )	14	(240 )
NET LOSS	\$(97 )	\$(5,854 )	\$(297 )	\$(5,469 )
Net loss per share—Basic	\$(0.02 )	\$(0.99 )	\$(0.05 )	\$(0.92 )
Net loss per share—Diluted	\$(0.02 )	\$(0.99 )	\$(0.05 )	\$(0.92 )
Weighted-Average Shares Outstanding—Basic	5,930	5,916	5,928	5,915
Weighted-Average Shares Outstanding—Diluted	5,930	5,916	5,928	5,915

See notes to condensed consolidated financial statements.



DATAWATCH CORPORATION  
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)  
(In thousands)

	Six Months Ended March 31,	
	2010	2009
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>		
Net loss	\$(297 )	\$(5,469 )
Adjustments to reconcile net loss to cash provided by operating activities:		
Impairment of goodwill and other intangible assets	-	6,401
Depreciation and amortization	653	448
Provision for doubtful accounts and sales returns	176	(7 )
Stock-based compensation	102	114
Deferred income taxes	-	(262 )
Changes in current assets and liabilities:		
Accounts receivable	345	418
Inventories	4	13
Prepaid expenses and other assets	(124 )	(115 )
Accounts payable, accrued expenses and other liabilities	(127 )	(314 )
Deferred revenue	86	172
Cash provided by operating activities	818	1,399
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>		
Purchases of equipment and fixtures	(47 )	(85 )
Capitalized software development costs	-	(543 )
Decrease in restricted cash	18	18
(Increase) decrease in other assets	(2 )	1
Cash used in investing activities	(31 )	(609 )
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>		
Proceeds from exercise of stock options	-	-
Cash provided by financing activities	-	-
<b>EFFECT OF EXCHANGE RATE CHANGES ON CASH AND EQUIVALENTS</b>	(99 )	(547 )
<b>INCREASE IN CASH AND EQUIVALENTS</b>	688	243
<b>CASH AND EQUIVALENTS, BEGINNING OF PERIOD</b>	5,649	4,885
<b>CASH AND EQUIVALENTS, END OF PERIOD</b>	\$6,337	\$5,128
<b>SUPPLEMENTAL INFORMATION:</b>		
Income taxes paid	\$27	\$8

See notes to condensed consolidated financial statements.



DATAWATCH CORPORATION  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
(UNAUDITED)

Note 1 - Summary of Significant Accounting Policies

Basis of Presentation and Principles of Consolidation

The accompanying condensed consolidated financial statements include the accounts of Datawatch Corporation (the “Company”) and its wholly-owned subsidiaries and have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission regarding interim financial reporting. Accordingly, they do not include all of the information and notes required by accounting principles generally accepted in the United States of America (“GAAP”) for complete financial statements and should be read in conjunction with the audited consolidated financial statements included in the Company’s Annual Report on Form 10-K for the year ended September 30, 2009 filed with the Securities and Exchange Commission (the “SEC”). All intercompany accounts and transactions have been eliminated.

In the opinion of management, the accompanying condensed consolidated financial statements have been prepared on the same basis as the audited consolidated financial statements for the fiscal year ended September 30, 2009, and include all adjustments necessary for fair presentation of the results of the interim periods presented. The operating results for the interim periods presented are not necessarily indicative of the results expected for the full year. The Company considers events or transactions that occur after the balance sheet date but before the financial statements are issued to provide additional evidence relative to certain estimates or to identify matters that require additional disclosure.

The preparation of financial statements in conformity with GAAP requires management to make estimates and judgments, which are evaluated on an on-going basis, that affect the amounts reported in the Company’s condensed consolidated financial statements and accompanying notes. Management bases its estimates on historical experience and on various other assumptions that it believes are reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results could differ from those estimates and judgments. In particular, significant estimates and judgments include those related to revenue recognition, allowance for doubtful accounts, sales returns reserve, useful lives of property and equipment, valuation of net deferred tax assets, business combinations, valuation of intangible assets and valuation of share-based awards.

Revenue Recognition

Revenue allocated to software products, specified upgrades and enhancements is recognized upon delivery of the related product, upgrades or enhancements. Revenue is allocated by vendor specific objective evidence (“VSOE”) of fair value to post-contract customer support (primarily maintenance) and is recognized ratably over the term of the support, and revenue allocated using VSOE to service elements (primarily training and consulting) is recognized as the services are performed. The residual method of revenue recognition is used for multi-element arrangements when the VSOE of the fair value does not exist for one of the delivered elements. Under the residual method, the arrangement fee is recognized as follows: (1) the total fair value of the undelivered elements, as supported by VSOE, is deferred and subsequently recognized as such items are delivered or completed and (2) the difference between the total arrangement fee and the amount allocated to the undelivered elements is recognized as revenue related to the delivered elements.

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The Company has two types of software product offerings: (1) Enterprise Software and (2) Desktop and Server Software. Enterprise Software products are sold directly to end-users and through value added resellers. The Company sells its Desktop and Server Software products directly to end-users and through distributors and resellers. Sales to distributors and resellers accounted for approximately 42% and 36%, respectively, of total sales for the three months ended March 31, 2010 and 2009, and 44% and 39%, respectively, of total sales for the six months ended March 31, 2010 and 2009. Revenue from the sale of all software products (when separately sold) is

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generally recognized at the time of shipment, provided there are no uncertainties surrounding product acceptance, the fee is fixed or determinable, collection is considered probable, persuasive evidence of the arrangement exists and there are no significant obligations remaining. Both types of the Company's software product offerings are "off-the-shelf" as such term is customarily defined. The Company's software products can be installed and used by customers on their own with little or no customization required. Multi-user licenses marketed by the Company are sold as a right to use the number of licenses and license fee revenue is recognized upon delivery of all software required to satisfy the number of licenses sold. Upon delivery, the licensing fee is payable without further delivery obligations to the Company.

Desktop and Server Software products are generally not sold in multiple element arrangements. Enterprise Software sales are generally multiple element arrangements which may include software licenses, professional services and post-contract customer support. In such multiple element arrangements, the Company applies the residual method in determining revenue to be allocated to the software license. In applying the residual method, the Company deducts from the sale proceeds the VSOE of fair value of the professional services and post-contract customer support in determining the residual fair value of the software license. The VSOE of fair value of the services and post-contract customer support is based on the amounts charged for these elements when sold separately. Professional services include implementation, integration, training and consulting services with revenue recognized as the services are performed. These services are generally delivered on a time and materials basis, are billed on a current basis as the work is performed, and do not involve modification or customization of the software or any other unusual acceptance clauses or terms. Post-contract customer support is typically provided under a maintenance agreement which provides technical support and rights to unspecified software maintenance updates and bug fixes on a when-and-if available basis. Revenue from post-contract customer support services is deferred and recognized ratably over the period of support (generally one year). Such deferred amounts are recorded as part of deferred revenue in the Company's condensed consolidated balance sheets.

The Company also licenses its Enterprise Software using a subscription model. At the time a customer enters into a binding agreement to purchase a subscription, the customer is invoiced for an initial 90 day service period and an account receivable and deferred revenue are recorded. Beginning on the date the software is installed at the customer site and available for use by the customer, and provided that all other criteria for revenue recognition are met, the deferred revenue amount is recognized ratably over the period the service is provided. The customer is then invoiced every 90 days and revenue is recognized ratably over the period of the subscription. The subscription arrangement includes software, maintenance and unspecified future upgrades including major version upgrades. The subscription renewal rate is the same as the initial subscription rate. Subscriptions can be cancelled by the customer at any time by providing 90 days prior written notice following the first year of the subscription term.

The Company's software products are sold under warranty against certain defects in material and workmanship for a period of 30 days from the date of purchase. Certain software products, including desktop versions of Monarch, Monarch Data Pump, BI Server and VortexXML sold directly to end-users, include a guarantee under which such customers may return products within 30 days for a full refund. Additionally, the Company provides its distributors with stock-balancing rights. Revenue from the sale of software products to distributors and resellers is recognized at the time of shipment providing all other criteria for revenue recognition are met and (i) the distributor or reseller is unconditionally obligated to pay for the products, including no contingency as to product resale, (ii) the distributor or reseller has independent economic substance apart from the Company, (iii) the Company is not obligated for future performance to bring about product resale, and (iv) the amount of future returns can be reasonably estimated. The Company's experience and history with its distributors and resellers allows for reasonable estimates of future returns. Among other things, estimates of potential future returns are made based on the inventory levels at, and the returns history with, the various distributors and resellers, which the Company monitors frequently.

#### Stock-Based Compensation

All share-based awards, including grants of employee stock options, are recognized in the financial statements based on their fair value.

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The Company recognizes the fair value of share-based awards over the requisite service period of the individual awards, which generally equals the vesting period. All of the Company's share-based awards are accounted for as equity instruments and there have been no liability awards granted. See additional stock-based compensation disclosure in Note 4 to the Company's condensed consolidated financial statements.

#### Concentration of Credit Risks and Major Customers

The Company sells its products and services to U.S. and non-U.S. dealers and other software distributors, as well as to end users, under customary credit terms. Three customers, Ingram Micro, Inc., Tech Data Corporation and Lifeboat Distribution, individually accounted for the following percentages of total revenue and accounts receivable for the periods indicated:

	Percentage of total revenue for the three months ended March 31,		Percentage of total revenue for the six months ended March 31,		Percentage of total accounts receivable at March 31, September 30,	
	2010	2009	2010	2009	2010	2009
Ingram Micro, Inc.	11%	16%	13%	19%	14%	24%
Tech Data Corporation	7%	7%	9%	6%	12%	7%
Lifeboat Distribution	13%	3%	10%	4%	19%	4%

The Company sells to Ingram Micro, Inc., Tech Data Corporation and Lifeboat Distribution under separate distribution agreements which automatically renew for successive one-year terms unless terminated. Other than these three customers, no other customer constitutes a significant portion (more than 10%) of revenues or accounts receivable. The Company performs ongoing credit evaluations of its customers and generally does not require collateral. Allowances are provided for anticipated doubtful accounts and sales returns based on management's review of receivables, inventory and historical trends.

#### Capitalized Software Development Costs

The Company capitalizes certain software development costs as well as purchased software upon achieving technological feasibility of the related products. Software development costs incurred and software purchased prior to achieving technological feasibility are charged to research and development expense as incurred. Commencing upon initial product release, capitalized costs are amortized to cost of software licenses using the straight-line method over the estimated life of the product (which approximates the ratio that current gross revenues for a product bear to the total of current and anticipated future gross revenues for that product), which is generally 18 to 36 months. The net amount of capitalized software development costs and purchased software was approximately \$738,000 and \$1,106,000 at March 31, 2010 and September 30, 2009, respectively. The Company did not capitalize any software development costs during the six months ended March 31, 2010. During the six months ended March 31, 2009, the Company capitalized approximately \$543,000 of software development costs related to new products in development.

#### Intangible Assets

Intangible assets consist of internally developed software, acquired technology, patents, customer lists and non-compete agreements acquired through business combinations. The values allocated to the majority of these intangible assets are amortized using the straight-line method over the estimated useful life of the related asset and are

recorded in cost of software licenses and subscriptions. The values allocated to customer relationships and non-compete agreements are amortized using the straight-line method over the estimated useful life of the related asset and are recorded in sales and marketing expenses. Intangible assets are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of the asset may not be recoverable and an

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impairment loss is recognized when it is probable that the estimated cash flows are less than the carrying amount of the asset.

## Income Taxes

Deferred income taxes are provided for the tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes and operating loss carryforwards and credits. Valuation allowances are recorded to reduce the net deferred tax assets to amounts the Company believes are more likely than not to be realized.

## Cash and Equivalents

Cash and equivalents include cash on hand, cash deposited with banks and highly liquid securities consisting of money market investments. The Company's cash equivalents are carried at fair value, which is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. The Company classifies the inputs used to measure fair value into the following hierarchy:

- Level 1 – Observable inputs such as quoted prices in active markets;
- Level 2 – Inputs, other than the quoted prices in active markets, that are observable either directly or indirectly; and
- Level 3 – Unobservable inputs in which there is little or no market data, which require the reporting entity to develop its own assumptions.

The following table represents information about the Company's cash equivalents measured at fair value on a recurring basis at March 31, 2010 (in thousands):

		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
	Total			
Money market funds	\$ 2,233	\$ 2,233	\$ -	\$ -

## Recent Accounting Pronouncements

In May 2009, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Codification ("ASC") 855, "Subsequent Events" (formerly Statement of Financial Accounting Standards ("SFAS") No. 165, "Subsequent Events"). This standard established principles and requirements for the accounting for and disclosure of subsequent events, including (a) the period after the balance sheet date to evaluate, (b) circumstances that would be considered a subsequent event and (c) disclosure requirements. ASC 855 was effective for fiscal years and interim periods ending after June 15, 2009. The implementation of this standard did not have a material impact on the Company's condensed consolidated financial statements.

In June 2009, the FASB issued ASC 105, "Generally Accepted Accounting Principles" (formerly SFAS No. 168, "FASB Accounting Standards Codification™ and the Hierarchy of Generally Accepted Accounting Principles." SFAS No. 168 replaces SFAS No. 162, "The Hierarchy of Generally Accepted Accounting Principles." This standard established the FASB Accounting Standards Codification™ as the single official source of authoritative U.S. generally accepted accounting principles ("GAAP") recognized by the FASB to be applied by non-governmental entities. Rules and

interpretive releases of the Securities and Exchange Commission (“SEC”) under authority of federal securities laws are also sources of authoritative GAAP for SEC registrants. On the effective date of this Standard, the Codification superseded all then-existing non-SEC accounting and reporting standards. All other non-grandfathered non-SEC accounting literature not included in the Codification became non authoritative. This Statement was effective for financial statements issued for interim and annual

periods ending after September 15, 2009 and the Company adopted this standard in the first quarter of its fiscal year 2010. The adoption of ASC 105 did not have a material effect on the Company's condensed consolidated financial statements.

In October 2009, the FASB issued Accounting Standards Update No. 2009-13, "Multiple-Deliverable Revenue Arrangements, a consensus of the FASB Emerging Issues Task Force" ("ASU 2009-13"). ASU 2009-13 provides principles for allocation of consideration among its multiple-elements, allowing more flexibility in identifying and accounting for separate deliverables under an arrangement. The ASU introduces an estimated selling price method for valuing the elements of a bundled arrangement if vendor-specific objective evidence or third-party evidence of selling price is not available, and significantly expands related disclosure requirements. This standard is effective on a prospective basis for revenue arrangements entered into or materially modified in fiscal years beginning on or after June 15, 2010. Alternatively, adoption may be on a retrospective basis, and early application is permitted. The Company does not expect the adoption of this standard to have a material effect on its condensed consolidated financial statements or disclosures.

## Note 2 – Intangible Assets, Net

Intangible assets, net, were comprised of the following as of March 31, 2010 and September 30, 2009:

	Weighted Average Useful Life in Years	March 31, 2010			September 30, 2009		
		Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount (in thousands)	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
Identified Intangible Asset							
Capitalized software	2	\$ 2,659	\$ 1,991	\$ 668	\$ 2,659	\$ 1,673	\$ 986
Purchased software	5	700	629	71	700	580	120
Patents	20	160	45	115	160	41	119
Customer lists	10	1,790	780	1,010	1,790	697	1,093
Non-compete agreements	4	640	629	11	640	561	79
Trademark	2	21	21	-	21	21	-
Total		\$ 5,970	\$ 4,095	\$ 1,875	\$ 5,970	\$ 3,573	\$ 2,397

For the three months ended March 31, 2010 and 2009, amortization expense related to intangible assets was \$277,000 and \$148,000, respectively. For the six months ended March 31, 2010 and 2009, amortization expense related to intangible assets was \$522,000 and \$284,000, respectively.

The estimated future amortization expense related to intangible assets as of March 31, 2010 is as follows:

Fiscal Years Ended September 30,	(In thousands)
Remainder of fiscal 2010	\$ 441
2011	556
2012	188
2013	174
2014	174

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2015	174
Thereafter	168
Total estimated future amortization expense	\$ 1,875

Note 3 – Income Taxes

The Company recognized deferred tax liabilities for the excess of tax-deductible goodwill over goodwill for

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financial reporting purposes. The tax benefit for the excess tax-deductible goodwill is recognized when realized on the tax return. During fiscal year 2006, Datawatch acquired the business assets of IDARS that resulted in tax-deductible amortization being recognized as a deferred tax expense. As the goodwill was deducted for tax purposes, a deferred tax expense was recognized each period with a corresponding deferred tax liability equal to the excess of tax amortization over the amortization for financial reporting purposes. During the three and six months ended March 31, 2009, the Company recorded deferred tax expense of approximately \$29,000 and \$58,000, respectively. During the second quarter of fiscal year 2009, the applicable goodwill associated with this purchase was determined to be fully impaired and written off for book purposes but continues to be deductible over a 15 year life for tax reporting purposes. Accordingly, upon impairment, the Company recorded a deferred tax asset, with a corresponding full valuation allowance, for the future tax benefit of the goodwill based on the Company's effective tax rate for the period. In connection with the goodwill impairment write-off, the Company reversed its cumulative deferred tax liability of approximately \$319,000 which was recorded as a reduction to the Company's income tax provision in the three and six months ended March 31, 2009.

Additionally, during the three and six months ended March 31, 2010, the Company recorded \$6,000 and \$14,000, respectively, related to estimated alternative minimum taxes and uncertain tax positions relative to foreign taxes. During the three and six months ended March 31, 2009, the Company recorded \$6,000 and \$21,000, respectively, related to estimated alternative minimum taxes and uncertain tax positions relative to foreign taxes.

#### Deferred Tax Assets

The Company's deferred tax assets include net operating loss carry forwards and tax credits that expire at different times through and until 2028. Significant judgment is required in determining the Company's provision for income taxes, the carrying value of deferred tax assets and liabilities and the valuation allowance recorded against net deferred tax assets. Factors such as future reversals of deferred tax assets and liabilities, projected future taxable income, changes in enacted tax rates and the period over which the Company's deferred tax assets will be recoverable are considered in making these determinations. Management does not believe the deferred tax assets are more likely than not to be realized and a full valuation allowance has been provided against the deferred tax assets at March 31, 2010 and September 30, 2009.

#### Provision for Uncertain Tax Positions

At September 30, 2009, the Company had a \$125,000 tax liability related to tax exposures that could result in cash payments, of which approximately \$6,000 and \$12,000, respectively, were recorded during the three and six months ended March 31, 2009. The Company increased its tax liability by \$6,000 during each of the three months ended December 31, 2009 and March 31, 2010. The Company also recorded additional uncertain tax positions of approximately \$2,000 and \$4,000, respectively, during the three and six months ended March 31, 2010 which were recorded as a reduction of the Company's deferred tax asset and its valuation allowance. The Company does not expect its tax liability to change significantly during the next twelve months. The Company's policy is to recognize interest and penalties related to uncertain tax positions as a component of income tax expense in its consolidated statements of operations. To date, the Company has not accrued any amounts for interest and penalties associated with this liability as such amounts have been de minimis.

The Company's unrecognized tax benefits (before consideration of any valuation allowance) represent differences between tax positions taken by the Company in its various consolidated and separate worldwide tax returns and the benefits recognized and measured. This amount also represents the amount of unrecognized tax benefits that, if recognized, would favorably affect the effective income tax rate in any future periods. The change in the unrecognized tax benefits during the six months ended March 31, 2010 was as follows:

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Balance at October 1, 2009	\$	793
Additions for prior year tax positions		17
Balance at March 31, 2010	\$	810

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In the normal course of business, the Company is subject to examination by taxing authorities throughout the world, including such jurisdictions as the United Kingdom, Australia, and the United States, and as a result, files numerous consolidated and separate income tax returns in the U.S. federal jurisdiction and various state and foreign jurisdictions. The fiscal years ended September 30, 2006 through September 30, 2009 are generally still open to examination in the jurisdictions listed above.

#### Note 4 – Shareholders' Equity

Stock-based compensation expense for the three months ended March 31, 2010 and 2009 was \$50,000 and \$56,000, respectively, and \$102,000 and \$114,000 for the six months ended March 31, 2010 and 2009, respectively, as included in the following expense categories:

	Three months ended March 31,		Six months ended March 31,	
	2010	2009	2010	2009
	(In thousands)			
Sales and marketing	\$11	\$12	\$23	\$26
Engineering and product development	3	4	7	7
General and administrative	36	40	72	81
	\$50	\$56	\$102	\$114

The Company's stock compensation plans provide for the granting of restricted stock units and either incentive or non-qualified stock options to employees and non-employee directors. Options and restricted stock units are subject to terms and conditions determined by the Compensation and Stock Committee of the Board of Directors. Options generally vest over a three year period beginning three months from the date of grant and expire either seven or ten years from the date of grant. Restricted stock units vest annually over a three year period.

#### Stock Options

The Company uses the Black-Scholes option-pricing model to calculate the fair value of options. The key assumptions for this valuation method include the expected life of the option, stock price volatility, risk-free interest rate and dividend yield. No options were granted under the stock option plans for the three months ended March 31, 2010. The weighted-average fair value of options granted under the stock option plans for the three months ended March 31, 2009 was \$0.97. The weighted-average fair values of options granted under the stock option plans for the six months ended March 31, 2010 and 2009 was \$1.43 and \$0.97, respectively. No options were exercised during the three or six months ended March 31, 2010 or 2009. As of March 31, 2010, there was \$118,000 of total unrecognized compensation cost related to non-vested stock option arrangements, which is expected to be recognized over a weighted-average period of 1.60 years.

Many of the assumptions used in the determination of compensation expense are judgmental and highly volatile. The table below indicates the key assumptions used in the option valuation calculations for options granted in the six months ended March 31, 2010 and 2009:

	2010	2009
Expected life	5 years	5 years
Expected volatility	75.33%	73.42%
Weighted-average volatility	75.33%	73.42%
Risk free interest rate	1.28%	1.88%
Dividend yield	0.0%	0.0%

The expected option life is based on historical trends and data. With regard to the expected option life assumption, the Company considers the exercise behavior of past grants and models the pattern of aggregate exercises. Patterns are determined on specific criteria of the aggregate pool of optionees including the reaction to

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vesting, realizable value and short-time-to-maturity effect. The Company uses an expected stock-price volatility assumption that is based on historical volatilities of the underlying stock which are obtained from public data sources. The risk-free interest rate is equal to the historical U.S. Treasury zero-coupon bond rate with a remaining term equal to the expected life of the option. The dividend yield of zero is based on the fact that the Company has never paid cash dividends and has no present intention to pay cash dividends. Based on the Company's historical voluntary turnover rates, an annualized estimated forfeiture rate of 10% has been used in calculating the estimated cost. Additional expense will be recorded if the actual forfeiture rate is lower than estimated, and a recovery of prior expense will be recorded if the actual forfeiture rate is higher than estimated.

The following table summarizes information about the Company's stock option plans for the six months ended March 31, 2010.

	Number of Options Outstanding	Weighted- Average Exercise Price	Weighted- Average Remaining Contractual Term	Aggregate Intrinsic Value \$(000)
Outstanding, October 1, 2009	548,800	\$ 3.05		
Granted	30,500	2.35		
Canceled	(25,288)	5.09		
Exercised	—	—		
Outstanding, March 31, 2010	554,012	\$ 2.92	4.07	\$ 260
Vested or expected to vest, March 31, 2010	546,756	\$ 2.92	3.87	\$ 259
Exercisable, March 31, 2010	481,455	\$ 2.88	3.82	\$ 242

#### Restricted Stock Units

The Company periodically grants awards of restricted stock units ("RSU") to each of its non-employee directors and some of its management team on a discretionary basis pursuant to its 2006 Equity Compensation and Incentive Plan. Each RSU entitles the holder to receive, at the end of each vesting period, a specified number of shares of the Company's common stock. The total number of RSUs unvested at March 31, 2010 was 44,173. Each RSU vests at the rate of 33.33% on each of the first through third anniversaries of the grant date with final vesting of the most recent grants scheduled to occur in March 2013. The fair value related to the RSUs was calculated based on the average stock price of the Company's common stock on the date of the grant and is being amortized evenly on a pro-rata basis over the vesting period to general and administrative expense. The fair value of the RSUs granted in the six months ended March 31, 2010 and 2009, respectively, was approximately \$59,000 (or \$2.39 weighted-average fair value per share) and \$31,000 (or \$1.27 fair value per share). The Company recorded compensation expense related to RSUs of approximately \$13,000 and \$10,000 for the three months ended March 31, 2010 and 2009, respectively, and \$26,000 and \$20,000 for the six months ended March 31, 2010 and 2009, respectively. These amounts are included in the total stock-based compensation expense disclosed above. As of March 31, 2010, there was \$93,000 of total unrecognized compensation cost related to RSUs, which is expected to be recognized over a weighted average period of 2.24 years.

The following table presents RSU information for the six months ended March 31, 2010:

Number of

	RSUs Outstanding	
Outstanding, October 1, 2009	39,494	
Granted	24,500	
Canceled	(2,501	)
Vested	(17,320	)
Outstanding, March 31, 2010	44,173	

## Note 5 - Comprehensive Income (Loss)

The following table sets forth the reconciliation of net loss to comprehensive loss:

	Three Months Ended March 31,		Six Months Ended March 31,	
	2010	2009	2010	2009
	(In thousands)			
Net loss	\$ (97 )	\$ (5,854 )	\$ (297 )	\$ (5,469 )
Other comprehensive loss:				
Foreign currency translation adjustments	(32 )	(27 )	(49 )	(352 )
Comprehensive loss	\$ (129 )	\$ (5,881 )	\$ (346 )	\$ (5,821 )

Accumulated other comprehensive loss reported in the condensed consolidated balance sheets consists solely of foreign currency translation adjustments.

## Note 6 - Basic and Diluted Net Income Per Share

Basic net income (loss) per common share is computed by dividing net income or loss by the weighted-average number of common shares outstanding during the period. Diluted net income (loss) per share reflects the impact, when dilutive, of the exercise of stock options and RSUs using the treasury stock method. Diluted net loss per share for the three and six months ended March 31, 2010 is the same as basic net loss per share as the potentially dilutive securities are all anti-dilutive.

Potentially dilutive common stock options aggregating 304,990 and 514,874 shares for the three months ended March 31, 2010 and 2009, respectively, and 305,711 and 512,048 shares for the six months ended March 31, 2010 and 2009, respectively, have been excluded from the computation of diluted net income per share because their inclusion would be anti-dilutive. Potentially dilutive restricted stock units aggregating 6,672 and 21,670 shares for the three months ended March 31, 2010 and 2009, respectively, and 5,830 and 18,787 shares for the six months ended March 31, 2010 and 2009, respectively, have been excluded from the computation of diluted net income per share because their inclusion would be anti-dilutive.

## Note 7 - Commitments and Contingencies

On August 11, 2004, the Company acquired 100% of the shares of Mergence Technologies Corporation. The purchase agreement includes a provision for quarterly cash payments to the former Mergence shareholders equal to 10% of revenue, as defined, of the Datawatch Researcher product until September 30, 2010. No amounts were expensed under this agreement for the three and six months ended March 31, 2010. The Company expensed approximately \$5,000 for the three and six months ended March 31, 2009 which is included in cost of software licenses and subscriptions.

The Company is also obligated to pay royalties ranging from 7% to 50% on revenue generated by the sale of certain licensed software products. Royalty expense included in cost of software licenses was approximately \$382,000 and \$404,000, respectively, for the three months ended March 31, 2010 and 2009 and \$727,000 and \$795,000, respectively, for the six months ended March 31, 2010 and 2009. The Company is not obligated to pay any minimum amounts for royalties.

From time to time, the Company is subject to claims and may be party to actions that arise in the normal course of business. The Company is not party to any litigation that management believes will have a material adverse effect on the Company's consolidated financial condition or results of operations.

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# Note 8 - Segment Information

The Company has determined that it has only one reportable segment. The Company's chief operating decision maker, its Chief Executive Officer, does not manage any part of the Company separately, and the allocation of resources and assessment of performance is based solely on the Company's consolidated operations and operating results.

The following table presents information about the Company's revenue by product lines:

	Three Months Ended March 31,		Six Months Ended March 31,	
	2010	2009	2010	2009
Business Intelligence Solutions (including Monarch, Monarch Data Pump, Monarch RMS, Monarch BI Server, Datawatch ES, Datawatch Dashboards, Datawatch Researcher, Visual Insight, iMergence and VortexXML)	70%	73%	70%	72%
Content Management Solutions (including Datawatch BDS)	18%	15%	18%	16%
Service Management Solutions (including Visual QSM and Visual HD)	12%	12%	12%	12%
Total	100%	100%	100%	100%

The Company conducts operations in the U.S. and internationally (principally in the United Kingdom). The following table presents information about the Company's geographic operations:

	Domestic	International (Primarily U.K.)	Intercompany Eliminations	Total
	(In thousands)			
<b>Total Revenue</b>				
Three months ended March 31, 2010	\$ 3,682	\$ 1,105	\$ (216 )	\$ 4,571
Three months ended March 31, 2009	\$ 4,126	\$ 1,199	\$ (233 )	\$ 5,092
Six months ended March 31, 2010	\$ 7,072	\$ 2,168	\$ (434 )	\$ 8,806
Six months ended March 31, 2009	\$ 8,354	\$ 2,414	\$ (474 )	\$ 10,294
<b>Total Operating Loss</b>				
Three months ended March 31, 2010	\$ (55 )	\$ (37 )	\$ —	\$ (92 )
Three months ended March 31, 2009	\$ (6,205 )	\$ 74	\$ —	\$ (6,131 )
Six months ended March 31, 2010	\$ (130 )	\$ (152 )	\$ —	\$ (282 )
Six months ended March 31, 2009	\$ (5,971 )	\$ 99	\$ —	\$ (5,872 )
<b>Non-current Assets</b>				
At March 31, 2010	\$ 2,351	\$ 46	\$ —	\$ 2,397
At September 30, 2009	\$ 2,981	\$ 40	\$ —	\$ 3,021

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

### GENERAL

The Company does not provide forecasts of its future financial performance. However, from time to time, information provided by the Company or statements made by its employees may contain "forward looking" information that involves risks and uncertainties. In particular, statements contained in this Quarterly Report on Form 10-Q that are not historical facts may constitute forward looking statements and are made under the safe harbor provisions of The Private Securities Litigation Reform Act of 1995. The Company cautions readers not to place undue reliance on any such forward looking statements, which speak only as of the date they are made. The Company disclaims any obligation, except as specifically required by law and the rules of the Securities and Exchange Commission, to publicly update or revise any such statements to reflect any change in the Company's expectations or in events, conditions or circumstances on which any such statements may be based, or that may affect the likelihood that actual results will differ from those set forth in the forward looking statements. The Company's actual results of operations and financial condition have varied and may in the future vary significantly from those stated in any forward looking statements. Factors that may cause such differences include, without limitation, the risks, uncertainties and other information discussed in Item 1A of the Company's Annual Report on Form 10-K for the fiscal year ended September 30, 2009, as well as the accuracy of the Company's internal estimates of revenue and operating expense levels.

Datawatch is engaged in the design, development, manufacture, marketing, and support of business computer software primarily for the Business Intelligence and Enterprise Information Management markets which include business intelligence, enterprise content management and service management solutions to allow organizations to access and analyze information in a more meaningful fashion.

The Company's principal product lines are Business Intelligence Solutions (including Monarch, Monarch Data Pump, Monarch RMS, Monarch BI Server, Datawatch ES, Datawatch Dashboards, Datawatch Researcher, Visual Insight, iMergence and VortexXML), Content Management Solutions (including Datawatch BDS and Datawatch MailManager) and Service Management Solutions (including Visual QSM and Visual HD). Included in the above categories are:

- Monarch, a desktop report mining and business intelligence application that lets users extract and manipulate data from ASCII report files, PDF files or HTML files produced on any mainframe, midrange, client/server or PC system;
- Monarch Data Pump, a data replication and migration tool that offers a shortcut for populating and refreshing data marts and data warehouses, for migrating legacy data into new applications and for providing automated delivery of reports in a variety of formats via email;
- Monarch RMS, a web-based report mining and analysis solution that integrates with any existing Enterprise Report Management document or content management archiving solution;
- Monarch BI Server, an out-of-the-box web-based Business Intelligence solution developed specifically for small to mid-sized businesses and departments;
- Datawatch ES, an enterprise business intelligence system that provides web-enabled report management, mining and distribution as well as data analysis and MS Excel integration;
- Datawatch Dashboards, an interactive dashboard solution that provides a visual overview of operational performance as well as the ability to monitor specific business processes and events;
- Datawatch Researcher, a development platform for building performance management, content and data aggregation and workflow solutions;
- Visual Insight, a performance management solution that provides web-based knowledge management and Key Performance Indicator reporting;
  - iMergence, an enterprise report mining system;

- VorteXML, a data transformation product for the emerging XML market that easily and quickly converts structured text output from any system into valid XML for web services and more using any DTD or XDR schema without programming;

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- Datawatch BDS, a system for high-volume document capture, archiving, and online presentation;
- Datawatch MailManager, a highly scalable email management solution that provides complete lifecycle, compliance and storage management for Microsoft Exchange environments;
- Visual QSM, a fully internet-enabled IT service management solution that incorporates workflow and network management capabilities and provides web access to multiple databases via a standard browser; and
- Visual Help Desk or Visual HD, a web-based help desk and call center solution operating on the IBM Lotus Domino platform.

The Company offers its enterprise products through perpetual licenses and subscription pricing models. Subscriptions automatically renew unless terminated with 90 days notice following the first year of the subscription term. The subscription arrangement includes software, maintenance and unspecified future upgrades including major version upgrades. The subscription renewal rate is the same as the initial subscription rate. During the three months ended March 31, 2010 and 2009, revenues under the subscription model were \$73,000 and \$120,000, respectively. During the six months ended March 31, 2010 and 2009, revenues under the subscription model were \$168,000 and \$256,000, respectively.

## CRITICAL ACCOUNTING POLICIES

In the preparation of financial statements and other financial data, management applies certain accounting policies to transactions that, depending on choices made by management, can result in different outcomes. In order for a reader to understand the following information regarding the financial performance and condition of the Company, an understanding of those accounting policies is important. Certain of those policies are comparatively more important to the Company's financial results and condition than others. The policies that the Company believes are most important for a reader's understanding of the financial information provided in this report are described below.

- Revenue Recognition, Allowance for Bad Debts and Returns Reserve
  - Income Taxes
  - Capitalized Software Development Costs
- Valuation of Intangible Assets and Other Long-Lived Assets
  - Accounting for Stock-Based Compensation

During the six months ended March 31, 2010, there were no significant changes in the Company's critical accounting policies. See Note 1 to the Company's condensed consolidated financial statements included in this Quarterly Report on Form 10-Q and in its Annual Report on Form 10-K for the year ended September 30, 2009 for additional information about these critical accounting policies, as well as a description of the Company's other significant accounting policies.

## RESULTS OF OPERATIONS

The following table sets forth certain statements of operations data as a percentage of total revenues for the periods indicated. The data has been derived from the unaudited condensed consolidated financial statements contained in this Quarterly Report on Form 10-Q. The operating results for any period should not be considered indicative of the results expected for any future period. This information should be read in conjunction with the Consolidated Financial Statements and Notes thereto included in the Company's Annual Report on Form 10-K for the fiscal year ended September 30, 2009.

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	Three Months Ended March 31,		Six Months Ended March 31,	
	2010	2009	2010	2009
REVENUE:				
Software licenses and subscriptions	56.7%	58.4%	54.0%	56.5%
Maintenance and services	43.3%	41.6%	46.0%	43.5%
Total Revenue	100.0%	100.0%	100.0%	100.0%
COSTS AND EXPENSES:				
Cost of software licenses and subscriptions	14.2%	10.4%	13.9%	10.3%
Cost of maintenance and services	16.3%	16.4%	17.1%	16.6%
Sales and marketing	34.8%	36.4%	35.6%	34.1%
Engineering and product development	15.5%	11.5%	16.1%	12.6%
General and administrative	21.2%	20.0%	20.5%	21.2%
Impairment of goodwill and other intangible assets	0.0%	125.7%	0.0%	62.2%
Total costs and expenses	102.0%	220.4%	103.2%	157.0%
LOSS FROM OPERATIONS	-2.0%	-120.4%	-3.2%	-57.0%
Interest income and other income (expense), net	0.0%	-0.1%	0.0%	1.6%
LOSS BEFORE INCOME TAXES	-2.0%	-120.5%	-3.2%	-55.4%
Provision (benefit) for income taxes	0.1%	-5.6%	0.2%	-2.3%
NET LOSS	-2.1%	-114.9%	-3.4%	-53.1%

Three Months Ended March 31, 2010 Compared to  
Three Months Ended March 31, 2009

### Total Revenues

The following table presents total revenue, total revenue decrease and percentage change in total revenue for the three months ended March 31, 2010 and 2009:

	Three Months Ended March 31,		Increase (Decrease)	Percentage Change
	2010	2009		
	(In thousands)			
Software licenses and subscriptions	\$ 2,593	\$ 2,973	\$ (380 )	-12.8%
Maintenance and services	1,978	2,119	(141 )	-6.7%
Total revenue	\$ 4,571	\$ 5,092	\$ (521 )	-10.2%

The decrease in software license and subscriptions revenue of \$380,000 for the three months ended March 31, 2010 consists of a \$444,000 decrease in Business Intelligence Solutions (including Monarch, Monarch Data Pump, Monarch RMS, Monarch BI Server, Datawatch ES, Datawatch Dashboards, Datawatch Researcher, Visual Insight, iMergence and VortexXML products), a \$25,000 decrease in Service Management Solutions (including Visual QSM

and Visual HD products) and an \$89,000 increase in Content Management Solutions (including Datawatch BDS). The Company attributes the overall decrease in software licenses and subscription revenue to softened demand for computer software due to the worldwide recession and customers' redistributing licenses of laid-off employees internally in lieu of purchasing additional licenses. The decrease in Business Intelligence Solutions is primarily due to decreased Monarch license sales as a result of the global recession as compared to the three months ended March 31, 2009.

The overall decrease in maintenance and services revenue of \$141,000 consists of a \$74,000 decrease in Business Intelligence Solutions (including Monarch, Monarch Data Pump, Monarch RMS, Monarch BI Server, Datawatch ES, Datawatch Dashboards, Datawatch Researcher, Visual Insight, iMergence and VortexXML

products), a \$57,000 decrease in Service Management Solutions (including Visual QSM and Visual HD products) and a \$10,000 decrease in Content Management Solutions (including Datawatch BDS). The Company attributes the overall decrease in maintenance and services revenue to softened demand for computer software due to the worldwide recession and lower renewal rates of annual maintenance contracts from existing customers. The decrease in Business Intelligence Solutions revenue was also the result of less demand for professional services work related to this product line during the three months ended March 31, 2010.

### Costs and Operating Expenses

The following table presents costs and operating expenses, increase (decrease) in costs and operating expenses and percentage changes in costs and operating expenses for the three months ended March 31, 2010 and 2009:

	Three Months Ended March 31,		Increase (Decrease)	Percentage Change	
	2010	2009			
	(In thousands)				
Cost of software licenses and subscriptions	\$ 648	\$ 531	\$ 117	22.0	%
Cost of maintenance and services	747	834	(87 )	-10.4	%
Sales and marketing	1,588	1,854	(266 )	-14.3	%
Engineering and product development	710	585	125	21.4	%
General and administrative	970	1,018	(48 )	-4.7	%
Impairment of goodwill and other intangible assets	—	6,401	(6,401 )	-100.0	%
Total costs and operating expenses	\$ 4,663	\$ 11,223	\$ (6,560 )	-58.5	%

The increase in cost of software licenses and subscriptions of \$117,000, or 22%, is primarily due to higher software amortization costs associated with new products released during fiscal 2009 which was partially offset by lower royalty costs associated with lower sales of Monarch.

The decrease in cost of maintenance and services of \$87,000, or approximately 10%, is primarily due to lower wages and other employee-related costs due to decreased headcount.

The decrease in sales and marketing expenses of \$266,000, or approximately 14%, is due to lower commissions resulting from lower sales as compared to the same period last year, a reduction in travel-related costs and also lower wages attributable to lower headcount as compared to the same period last year.

The increase in engineering and product development expenses of \$125,000, or approximately 21%, is primarily attributable to higher external consulting costs. The lower amount in the second quarter of fiscal 2009 is the result of development costs that were capitalized for new software releases in fiscal 2009.

The decrease in general and administrative expenses of \$48,000, or approximately 5%, is primarily attributable to lower employee-related costs, lower accounting and auditing fees and decreased use of outside consultants.

Impairment of goodwill and other intangible assets of \$6.4 million in fiscal 2009 is attributable to the full impairment of the Company's goodwill totaling \$6,116,000 and an indefinite lived trademark totaling \$285,000. The impairment assessment and resulting charge were completed and recorded in the three months ended March 31, 2009.

Interest income and other income (expense) includes primarily the following two components: interest income; and gains (losses) on foreign currency transactions. Interest income for the three months ended March 31, 2010 was less than \$1,000 as compared to \$5,000 for the three months ended March 31, 2009. The decrease in interest income is primarily the result of lower interest rates on interest bearing cash and equivalents. Gain (loss)

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on foreign currency transactions for the three months ended March 31, 2010 was a gain of \$1,000 as compared to a loss of \$12,000 for the three months ended March 31, 2009.

Income tax expense for the three months ended March 31, 2010 was \$6,000 as compared to an income tax benefit of \$284,000 for the three months ended March 31, 2009. Income tax expense for the three months ended March 31, 2010 represents a provision for uncertain tax positions relative to foreign taxes. Income tax benefit for the three months ended March 31, 2009 was primarily attributable to the reversal of the Company's cumulative deferred tax liability of \$319,000 related to its tax-deductible goodwill from the IDARS acquisition, which was determined to be fully impaired for book purposes as of March 31, 2009. Income tax benefit for the three months ended March 31, 2009 was partially offset by deferred tax expense recorded up to the impairment date totaling \$29,000 and uncertain tax positions relative to foreign taxes totaling \$6,000.

Net loss for the three months ended March 31, 2010 was \$97,000 as compared to net loss of \$5,854,000 for the three months ended March 31, 2009. The net loss in fiscal year 2009 includes a goodwill and trademark impairment charge totaling \$6,401,000.

#### Six months Ended March 31, 2010 Compared to Six Months Ended March 31, 2009

##### Total Revenues

The following table presents total revenue, total revenue decrease and percentage change in total revenue for the six months ended March 31, 2010 and 2009:

	Six Months Ended March 31, 2010		2009	Increase (Decrease)	Percentage Change	
	(In thousands)					
Software licenses and subscriptions	\$	4,759	\$	5,813	\$ (1,054 )	-18.1 %
Maintenance and services		4,047		4,481	(434 )	-9.7 %
Total revenue	\$	8,806	\$	10,294	\$ (1,488 )	-14.5 %

The decrease in software license and subscriptions revenue of \$1,054,000 for the six months ended March 31, 2010 consists of a \$1,104,000 decrease in Business Intelligence Solutions (including Monarch, Monarch Data Pump, Monarch RMS, Monarch BI Server, Datawatch ES, Datawatch Dashboards, Datawatch Researcher, Visual Insight, iMerge and VortexXML products), a \$40,000 decrease in Service Management Solutions (including Visual QSM and Visual HD products) and a \$90,000 increase in Content Management Solutions (including Datawatch BDS). The Company attributes the overall decrease in software licenses and subscriptions revenue to softened demand for computer software due to the worldwide recession and customers' redistributing licenses of laid off employees internally in lieu of purchasing additional licenses. The decrease in Business Intelligence Solutions is primarily due to decreased Monarch license sales as a result of the global recession as compared to the six months ended March 31, 2009.

The decrease in maintenance and services revenue of \$434,000 consists of a \$156,000 decrease in Content Management Solutions (including Datawatch BDS), a \$153,000 decrease in Service Management Solutions (including Visual QSM and Visual HD products) and a \$125,000 decrease in Business Intelligence Solutions (including Monarch, Monarch Data Pump, Monarch RMS, Monarch BI Server, Datawatch ES, Datawatch Dashboards, Datawatch Researcher, Visual Insight, iMerge and VortexXML products). The Company attributes the overall

decrease in maintenance and services revenue to softened demand for computer software due to the worldwide recession and lower renewal rates of annual maintenance contracts from existing customers. The decreases in Content Management Solutions and Service Management Solutions were also the result of less demand for professional services work related to these product lines during the six months ended March 31, 2010.

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## Costs and Operating Expenses

The following table presents costs and operating expenses, increase (decrease) in costs and operating expenses and percentage changes in costs and operating expenses for the six months ended March 31, 2010 and 2009:

	Six Months Ended March 31,		Increase (Decrease)		Percentage Change	
	2010	2009				
	(In thousands)					
Cost of software licenses and subscriptions	1,222	\$ 1,061	\$ 161		15.2	%
Cost of maintenance and services	1,506	1,707	(201 )		-11.8	%
Sales and marketing	3,135	3,515	(380 )		-10.8	%
Engineering and product development	1,419	1,298	121		9.3	%
General and administrative	1,806	2,184	(378 )		-17.3	%
Impairment of goodwill and other intangible assets	—	6,401	(6,401 )		-100.0	%
Total costs and operating expenses	\$ 9,088	\$ 16,166	\$ (7,078 )		-43.8	%

The increase in cost of software licenses and subscriptions of \$161,000, or approximately 15%, is primarily due to higher software amortization costs associated with new products released during fiscal 2009 which was partially offset by lower royalty costs associated with lower sales of Monarch.

The decrease in cost of maintenance and services of \$201,000, or approximately 12%, is primarily due to lower wages and other employee-related costs due to decreased headcount.

The decrease in sales and marketing expenses of \$380,000, or approximately 11%, is primarily due to lower commissions resulting from decreased sales, lower wages attributable to lower headcount as compared to the same period last year and lower external consulting costs.

The increase in engineering and product development expenses of \$121,000, or approximately 9%, is primarily due to higher external consulting costs as compared to the same period last year.

The decrease in general and administrative expenses of \$378,000, or approximately 17%, is primarily attributable to lower employee-related costs, lower accounting and auditing fees and decreased use of outside consultants.

Impairment of goodwill and other intangible assets of \$6.4 million in fiscal 2009 is attributable to the full impairment of the Company's goodwill totaling \$6,116,000 and an indefinite lived trademark totaling \$285,000. The impairment assessment and resulting charge were completed and recorded in the three months ended March 31, 2009.

Interest income and other income (expense) includes primarily the following two components: interest income; and gains (losses) on foreign currency transactions. Interest income for the six months ended March 31, 2010 was approximately \$1,000 as compared to \$27,000 for the six months ended March 31, 2009. The decrease in interest income is primarily the result of lower interest rates on interest bearing cash and equivalents. Gain (loss) on foreign currency transactions for the six months ended March 31, 2010 was a loss of \$2,000 as compared to a gain of \$136,000 for the six months ended March 31, 2009. The significant foreign currency gain recorded in the six months ended March 31, 2009 was primarily due to favorable foreign exchange rates in British pound denominated transactions during that period.

Income tax expense for the six months ended March 31, 2010 was \$14,000 as compared to an income tax

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benefit of \$240,000 for the six months ended March 31, 2009. Income tax expense for the six months ended March 31, 2010 primarily represents a provision for uncertain tax positions relative to foreign taxes. Income tax benefit for the six months ended March 31, 2009 was primarily attributable to the reversal of the Company's cumulative deferred tax liability of \$319,000 related to its tax-deductible goodwill from the IDARS acquisition, which was determined to be fully impaired for book purposes as of March 31, 2009. Income tax benefit for the six months ended March 31, 2009 was partially offset by deferred tax expense recorded up to the impairment date totaling \$58,000, uncertain tax positions relative to foreign taxes totaling \$12,000 and a provision for estimated alternative minimum taxes in the U.S. totaling \$9,000.

Net loss for the six months ended March 31, 2010 was \$297,000 as compared to net loss of \$5,469,000 for the six months ended March 31, 2009. The net loss in fiscal year 2009 includes a goodwill and trademark impairment charge totaling \$6,401,000.

#### OFF BALANCE SHEET ARRANGEMENTS, CONTRACTUAL OBLIGATIONS AND CONTINGENT LIABILITIES AND COMMITMENTS

The Company leases various facilities and equipment in the U.S. and overseas under non-cancelable operating leases that expire through 2013. The lease agreements generally provide for the payment of minimum annual rentals, pro rata share of taxes, and maintenance expenses. Rental expense for all operating leases was approximately \$76,000 and \$80,000 for the three months ended March 31, 2010 and 2009, respectively, and \$149,000 and \$163,000 for the six months ended March 31, 2010 and 2009, respectively.

As of March 31, 2010, the Company's contractual obligations include minimum rental commitments under non-cancelable operating leases and long-term liabilities related to uncertain tax positions as follows:

Contractual Obligations:	Total	Less than 1 Year	1-3 Years (in thousands)	3-5 Years	More than 5 Years
Operating Lease Obligations	\$313	\$265	\$47	\$1	\$—
Other Liabilities	\$137	\$—	\$—	\$—	\$137

The Company is also obligated to pay royalties ranging from 7% to 50% on revenue generated by the sale of certain licensed software products. Royalty expense included in cost of software licenses was approximately \$382,000 and \$404,000, respectively, for the three months ended March 31, 2010 and 2009, and \$727,000 and \$795,000 for the six months ended March 31, 2010 and 2009, respectively. The Company is not obligated to pay any minimum amounts for royalties.

On August 11, 2004, the Company acquired 100% of the shares of Mergence Technologies Corporation. The purchase agreement includes a provision for quarterly cash payments to the former Mergence shareholders equal to 10% of revenue, as defined, of the Datawatch Researcher and Visual Insight products until September 30, 2010. No amounts were expensed under this agreement for the three or six months ended March 31, 2010. The Company expensed approximately \$5,000 for the three months and six months ended March 31, 2009 which is included in cost of software licenses and subscriptions.

The Company's software products are sold under warranty against certain defects in material and workmanship for a period of 30 days from the date of purchase. If necessary, the Company would provide for the estimated cost of warranties based on specific warranty claims and claim history. However, the Company has never incurred significant

expense under its product or service warranties. As a result, the Company believes the estimated fair value of these warranty agreements is minimal. Accordingly, there are no liabilities recorded for warranty claims as of March 31, 2010.

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The Company is required by a sublease agreement related to its Chelmsford, Massachusetts facility to provide a letter of credit originally in the amount of approximately \$125,000 as a security deposit to the landlord of amounts due under the lease. In accordance with the terms of its sublease agreement, the Company is allowed to reduce its letter of credit by approximately \$18,000 annually following the completion of the first three years of its lease arrangement, which occurred during the first quarter of fiscal year 2009. Cash on deposit providing security in the amount of this letter of credit was \$89,000 and \$107,000 as of March 31, 2010 and September 30, 2009, respectively, and is classified as restricted cash in the Company's condensed consolidated balance sheets.

The Company enters into indemnification agreements in the ordinary course of business. Pursuant to these agreements, the Company generally agrees to indemnify, hold harmless, and reimburse the indemnified party for losses suffered or incurred by the indemnified party, generally its customers, in connection with any patent, copyright or other intellectual property infringement claim by any third party with respect to the Company's products. The term of these indemnification agreements is generally perpetual. The maximum potential amount of future payments the Company could be required to make under these indemnification agreements is unlimited. The Company has never incurred costs to defend lawsuits or settle claims related to these indemnification agreements. As a result, the Company believes the estimated fair value of these agreements is minimal. Accordingly, the Company has no liabilities recorded for these potential obligations as of March 31, 2010.

Certain of the Company's agreements also provide for the performance of services at customer sites. These agreements may contain indemnification clauses, whereby the Company will indemnify the customer from any and all damages, losses, judgments, costs and expenses for acts of its employees or subcontractors resulting in bodily injury or property damage. The maximum potential amount of future payments the Company could be required to make under these indemnification agreements is unlimited; however, the Company has general and umbrella insurance policies that would enable it to recover a portion of any amounts paid. The Company has never incurred costs to defend lawsuits or settle claims related to these indemnification agreements. As a result, the Company believes the estimated fair value of these agreements is minimal. Accordingly, the Company has no liabilities recorded for these potential obligations as of March 31, 2010.

As permitted under Delaware law, the Company has agreements with its directors whereby the Company will indemnify them for certain events or occurrences while the director is, or was, serving at the Company's request in such capacity. The term of the director indemnification period is for the later of ten years after the date that the director ceases to serve in such capacity or the final termination of proceedings against the director as outlined in the indemnification agreement. The maximum potential amount of future payments the Company could be required to make under these indemnification agreements is unlimited; however, the Company's director and officer insurance policy would enable 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 has no liabilities recorded for these potential obligations as of March 31, 2010.

## LIQUIDITY AND CAPITAL RESOURCES

Management believes that its current cash balances and cash generated from operations will be sufficient to meet the Company's cash needs for working capital and anticipated capital expenditures for at least the next twelve months. At March 31, 2010, the Company had \$6,337,000 of cash and equivalents, an increase of \$688,000 from September 30, 2009.

At March 31, 2010, the Company had working capital of approximately \$2,903,000 as compared to working capital of \$2,627,000 at September 30, 2009. The Company expects cash flows from operations to remain positive as it anticipates profitability in the future. However, if the Company's cash flow from operations were to decline significantly, it may need to consider further reductions to its operating expenses. The Company does not anticipate additional cash requirements to fund significant growth or the acquisition of complementary technology or businesses.

However, if in the future, such expenditures are anticipated or required, the Company may need to seek additional financing by issuing equity or obtaining credit facilities to fund such requirements. There can be no assurance that the Company will be able to issue additional equity or obtain a new credit facility at attractive prices or rates, or at all.

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The Company had a net loss of approximately \$297,000 for the six months ended March 31, 2010 as compared to a net loss of approximately \$5,469,000 for the six months ended March 31, 2009. The net loss in fiscal year 2009 was the result of a non-cash charge of \$6.4 million related to the impairment of goodwill and a trademark. During the six months ended March 31, 2010 and 2009, approximately \$818,000 and \$1,399,000, respectively, of cash was provided by the Company's operations. During the six months ended March 31, 2010, the main source of cash from operations were the adjustments to net loss for depreciation and amortization as well as a decrease in accounts receivable.

Net cash used in investing activities for the six months ended March 31, 2010 of \$31,000 is primarily related to the purchase of property and equipment which was partially offset by a reduction in the Company's letter of credit pursuant to its sublease agreement for its Chelmsford, Massachusetts facility.

The Mergence purchase agreement dated August 11, 2004 includes a provision for quarterly cash payments to the former Mergence shareholders equal to 10% of revenue, as defined, of the Datawatch Researcher and Visual Insight products for a period of six years. As the cash payments are based on recognized revenue and no minimum payments are required, they are not expected to have a significant impact on the Company's liquidity or cash flows. See the section titled "Off Balance Sheet Arrangements, Contractual Obligations and Contingent Liabilities and Commitments" included elsewhere herein for a more complete disclosure of the Company's commitments and contingent liabilities.

An existing agreement between Datawatch and Math Strategies grants the Company exclusive worldwide rights to use and distribute through April 30, 2015 certain intellectual property owned by Math Strategies and incorporated by the Company in its Monarch, Monarch Data Pump, VortexML and certain other products. The Company has also entered into an Option Purchase Agreement with Math Strategies giving the Company the option to purchase these intellectual property rights for a formula price based on a multiple of the aggregate royalties paid to Math Strategies by the Company for the four fiscal quarters preceding the exercise of the option. This option, if exercised, would provide the Company with increased flexibility to utilize the purchased technology in the future.

Management believes that the Company's current operations have not been materially impacted by the effects of inflation.

### Item 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

#### Derivative Financial Instruments, Other Financial Instruments, and Derivative Commodity Instruments

At March 31, 2010, the Company did not participate in or hold any derivative financial instruments or commodity instruments. The Company holds no investment securities that possess significant market risk.

#### Primary Market Risk Exposures

The Company's primary market risk exposure is foreign currency exchange rate risk. The Company's exposure to currency exchange rate fluctuations has been and is expected to continue to be modest due to the fact that the operations of its international subsidiaries are almost exclusively conducted in their respective local currencies, and dollar advances to the Company's international subsidiaries, if any, are usually considered to be of a long-term investment nature. Accordingly, the majority of currency movements are reflected in the Company's other comprehensive income (loss). There are, however, certain situations where the Company will invoice customers in currencies other than its own. Such gains or losses from operating activity, whether realized or unrealized, are reflected in interest income and other income (expense), net in the condensed consolidated statements of operations. Although the worldwide recession and significant fluctuations in the currency markets caused the Company's gain on foreign currency transactions to be more significant in fiscal 2009, such gains or losses have generally not been material in the past nor does management believe that they will be material in the future. Currently, the Company does not engage in foreign currency hedging activities.



Item 4. CONTROLS AND PROCEDURES

(a) Evaluation of Disclosure Controls and Procedures.

The principal executive officer and principal financial officer, with the participation of the Company's management, evaluated the effectiveness of the Company's disclosure controls and procedures as of March 31, 2010. The term "disclosure controls and procedures," as defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act, means controls and other procedures of a company that are designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is accumulated and communicated to the company's management, including its principal executive and principal financial officers, as appropriate to allow timely decisions regarding required disclosure. Management recognizes that any system of controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving their objectives. Based upon that evaluation, the Company's principal executive officer and principal financial officer concluded that the Company's disclosure controls and procedures are effective in enabling the Company to record, process, summarize and report information required to be included in the Company's periodic SEC filings within the required time period.

(b) Changes in Internal Controls.

No changes in our internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) occurred during the quarter ended March 31, 2010 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

## PART II. OTHER INFORMATION

### Item 1. Legal Proceedings

The Company is occasionally involved in legal proceedings and other claims arising out of its operations in the normal course of business. The Company is not party to any litigation that management believes will have a material adverse effect on the Company's consolidated financial condition, results of operations, or cash flows.

### Item 1A. Risk Factors

In addition to the other information set forth in this report, the reader should carefully consider the factors discussed in Part I, Item 1A under the heading "Risk Factors" in the Company's Annual Report on Form 10-K for the year ended September 30, 2009, which could materially affect its business, financial condition or future results. The risks described in the Company's Annual Report on Form 10-K are not the only risks facing the Company. Additional risks and uncertainties not currently known or that it currently deems to be immaterial also may materially adversely affect the Company's business, financial condition and/or operating results.

### Item 6. Exhibits

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| 31.1 | Certification of the Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.  |
| 31.2 | Certification of the Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.  |
| 32.1 | Certification of the Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |
| 32.2 | Certification of the Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |

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 May 14, 2010.

DATAWATCH CORPORATION

/s/ Kenneth P. Bero  
Kenneth P. Bero  
President, Chief Executive Officer, and  
Director (Principal Executive Officer)

/s/ Murray P. Fish  
Murray P. Fish  
Chief Financial Officer,  
(Principal Financial Officer)

