

MICROSTRATEGY INC  
Form 10-Q  
November 09, 2006  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

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**FORM 10-Q**

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

For the Quarterly Period Ended September 30, 2006

OR

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

For the transition period from            to

Commission File Number 000-24435

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**MICROSTRATEGY INCORPORATED**

(Exact name of registrant as specified in its charter)

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Delaware

(State of incorporation)

1861 International Drive, McLean, VA

(Address of Principal Executive Offices)

22102

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(Zip Code)

51-0323571

(I.R.S. Employer

Identification Number)

**Registrant's telephone number, including area code: (703) 848-8600**

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer  Accelerated filer  Non-accelerated filer

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

The number of shares of the registrant's class A common stock and class B common stock outstanding on November 1, 2006 was 9,544,048 and 3,101,209, respectively.

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**MICROSTRATEGY INCORPORATED**

**FORM 10-Q**

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**Table of Contents****PART I. FINANCIAL INFORMATION****ITEM 1. FINANCIAL STATEMENTS****MICROSTRATEGY INCORPORATED****CONSOLIDATED BALANCE SHEETS****(in thousands, except per share data)**

|   | September 30,       | December 31,      |
|---|---------------------|-------------------|
|   | 2006<br>(unaudited) | 2005<br>(audited) |
| <b>Assets</b>   |                     |                   |
| Current assets:   |                     |                   |
| Cash and cash equivalents   | \$ 47,828           | \$ 42,318         |
| Restricted cash and investments   | 3,833               | 5,076             |
| Short-term investments  | 15                  | 53,761            |
| Accounts receivable, net  | 41,701              | 43,052            |
| Prepaid expenses and other current assets   | 7,845               | 6,209             |
| Deferred tax assets, net  | 28,580              | 22,971            |
| <b>Total current assets</b>   | <b>129,802</b>      | <b>173,387</b>    |
| Property and equipment, net   | 10,600              | 12,031            |
| Capitalized software development costs, net   | 2,077               | 3,669             |
| Deposits and other assets   | 2,462               | 2,293             |
| Deferred tax assets, net  | 65,180              | 86,393            |
| <b>Total Assets</b>   | <b>\$ 210,121</b>   | <b>\$ 277,773</b> |
| <b>Liabilities and Stockholders Equity</b>  |                     |                   |
| Current liabilities:  |                     |                   |
| Accounts payable and accrued expenses   | \$ 19,853           | \$ 19,550         |
| Accrued compensation and employee benefits  | 25,474              | 27,258            |
| Deferred revenue and advance payments   | 57,139              | 45,874            |
| <b>Total current liabilities</b>  | <b>102,466</b>      | <b>92,682</b>     |
| Deferred revenue and advance payments   | 1,357               | 1,554             |
| Other long-term liabilities   | 2,015               | 2,815             |
| <b>Total Liabilities</b>  | <b>105,838</b>      | <b>97,051</b>     |
| <b>Commitments and Contingencies</b>  |                     |                   |
| <b>Stockholders Equity:</b>   |                     |                   |
| Preferred stock undesignated, \$0.001 par value; 5,000 shares authorized; no shares issued or outstanding   |                     |                   |
| Class A common stock, \$0.001 par value; 330,000 shares authorized; 13,430 shares issued and 9,376 shares outstanding, and 13,270 shares issued and 10,595 shares outstanding, respectively | 13                  | 13                |
| Class B common stock, \$0.001 par value; 165,000 shares authorized; 3,228 and 3,258 issued and outstanding, respectively  | 3                   | 3                 |
| Additional paid-in capital  | 434,681             | 428,062           |
| Treasury stock, at cost, 4,054 and 2,675 shares, respectively   | (268,776)           | (136,817)         |

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|   |                   |                   |
|---|-------------------|-------------------|
| Accumulated other comprehensive income            | 2,074             | 2,318             |
| Accumulated deficit                               | (63,712)          | (112,857)         |
| <b>Total Stockholders' Equity</b>                 | <b>104,283</b>    | <b>180,722</b>    |
| <b>Total Liabilities and Stockholders' Equity</b> | <b>\$ 210,121</b> | <b>\$ 277,773</b> |

The accompanying notes are an integral part of these Consolidated Financial Statements.

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**MICROSTRATEGY INCORPORATED**  
**CONSOLIDATED STATEMENTS OF OPERATIONS**

(in thousands, except per share data)

(unaudited)

|   | <b>Three Months Ended</b> |                  |
|---|---------------------------|------------------|
|   | <b>September 30,</b>      |                  |
|   | <b>2006</b>               | <b>2005</b>      |
| <b>Revenues:</b>                          |                           |                  |
| Product licenses                          | \$ 24,494                 | \$ 22,608        |
| Product support and other services        | 53,171                    | 43,202           |
| <b>Total revenues</b>                     | <b>77,665</b>             | <b>65,810</b>    |
| <b>Cost of Revenues:</b>                  |                           |                  |
| Product licenses                          | 826                       | 867              |
| Product support and other services        | 10,883                    | 8,412            |
| Total cost of revenues                    | 11,709                    | 9,279            |
| <b>Gross Profit</b>                       | <b>65,956</b>             | <b>56,531</b>    |
| <b>Operating Expenses:</b>                |                           |                  |
| Sales and marketing                       | 21,518                    | 16,652           |
| Research and development                  | 8,794                     | 7,820            |
| General and administrative                | 12,469                    | 9,179            |
| Amortization of intangible assets         | 18                        | 18               |
| <b>Total operating expenses</b>           | <b>42,799</b>             | <b>33,669</b>    |
| <b>Income from Operations</b>             | <b>23,157</b>             | <b>22,862</b>    |
| <b>Financing and Other Income:</b>        |                           |                  |
| Interest income, net                      | 583                       | 475              |
| Gain on investments                       | 14                        | 4                |
| Other (expense) income, net               | (208)                     | 248              |
| <b>Total financing and other income</b>   | <b>389</b>                | <b>727</b>       |
| <b>Income before income taxes</b>         | <b>23,546</b>             | <b>23,589</b>    |
| Provision for income taxes                | 6,574                     | 10,336           |
| <b>Net Income</b>                         | <b>\$ 16,972</b>          | <b>\$ 13,253</b> |
| Basic earnings per share (1)              | \$ 1.34                   | \$ 0.96          |
| Diluted earnings per share (1)            | \$ 1.27                   | \$ 0.91          |
| Basic weighted average shares outstanding | 12,707                    | 13,868           |

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|   |        |        |
|---|--------|--------|
| Diluted weighted average shares outstanding | 13,325 | 14,357 |
|---|--------|--------|

- (1) Basic and fully diluted earnings per share for class A and class B common stock are the same.  
The accompanying notes are an integral part of these Consolidated Financial Statements.

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**MICROSTRATEGY INCORPORATED**  
**CONSOLIDATED STATEMENTS OF OPERATIONS**

(in thousands, except per share data)

(unaudited)

|   | Nine Months Ended |                  |
|---|-------------------|------------------|
|   | September 30,     |                  |
|   | 2006              | 2005             |
| <b>Revenues:</b>                          |                   |                  |
| Product licenses                          | \$ 70,738         | \$ 68,674        |
| Product support and other services        | 150,531           | 122,559          |
| <b>Total revenues</b>                     | <b>221,269</b>    | <b>191,233</b>   |
| <b>Cost of Revenues:</b>                  |                   |                  |
| Product licenses                          | 2,122             | 3,062            |
| Product support and other services        | 29,752            | 24,007           |
| Total cost of revenues                    | 31,874            | 27,069           |
| <b>Gross Profit</b>                       | <b>189,395</b>    | <b>164,164</b>   |
| <b>Operating Expenses:</b>                |                   |                  |
| Sales and marketing                       | 61,800            | 50,419           |
| Research and development                  | 25,776            | 23,099           |
| General and administrative                | 33,935            | 26,304           |
| Amortization of intangible assets         | 53                | 54               |
| <b>Total operating expenses</b>           | <b>121,564</b>    | <b>99,876</b>    |
| <b>Income from Operations</b>             | <b>67,831</b>     | <b>64,288</b>    |
| <b>Financing and Other Income:</b>        |                   |                  |
| Interest income, net                      | 2,062             | 2,036            |
| Gain (loss) on investments                | 14                | (127)            |
| Other income (expense), net               | (876)             | 1,663            |
| <b>Total financing and other income</b>   | <b>1,200</b>      | <b>3,572</b>     |
| <b>Income before income taxes</b>         | <b>69,031</b>     | <b>67,860</b>    |
| Provision for income taxes                | 20,508            | 21,967           |
| <b>Net Income</b>                         | <b>\$ 48,523</b>  | <b>\$ 45,893</b> |
| Basic earnings per share (1)              | \$ 3.70           | \$ 3.05          |
| Diluted earnings per share (1)            | \$ 3.52           | \$ 2.91          |
| Basic weighted average shares outstanding | 13,097            | 15,071           |



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|   |        |        |
|---|--------|--------|
| Diluted weighted average shares outstanding | 13,766 | 15,748 |
|---|--------|--------|

- (1) Basic and fully diluted earnings per share for class A and class B common stock are the same.  
The accompanying notes are an integral part of these Consolidated Financial Statements.

**Table of Contents****MICROSTRATEGY INCORPORATED****CONSOLIDATED STATEMENTS OF CASH FLOWS**

(in thousands)

(unaudited)

|  | Nine Months Ended |                  |
|--|-------------------|------------------|
|  | September 30,     |                  |
|  | 2006              | 2005             |
| Operating activities:  |                   |                  |
| Net income   | \$ 48,523         | \$ 45,893        |
| Adjustments to reconcile net income to net cash provided by operating activities:                                    |                   |                  |
| Depreciation and amortization  | 5,755             | 6,405            |
| Bad debt provision   | 696               | 425              |
| Deferred taxes   | 17,532            | 14,539           |
| Stock-based compensation   | 1,086             |                  |
| Excess tax benefits from stock-based payment arrangements  | (2,208)           |                  |
| Other, net   | 145               | (345)            |
| Changes in operating assets and liabilities:   |                   |                  |
| Accounts receivable  | 1,874             | 10,665           |
| Prepaid expenses and other current assets  | (1,401)           | 213              |
| Deposits and other assets  | (142)             | 449              |
| Accounts payable and accrued expenses, compensation and employee benefits  | (3,078)           | (8,059)          |
| Deferred revenue and advance payments  | 9,504             | 3,361            |
| Other long-term liabilities  | (482)             | (1,088)          |
| <b>Net cash provided by operating activities</b>   | <b>77,804</b>     | <b>72,458</b>    |
| Investing activities:  |                   |                  |
| Proceeds from maturities of short-term investments   | 112,666           | 116,110          |
| Purchases of short-term investments  | (58,900)          | (87,143)         |
| Purchases of property and equipment, net   | (2,671)           | (1,284)          |
| Capitalized software development costs   |                   | (926)            |
| Decrease (increase) in restricted cash and investments   | 1,308             | (3,779)          |
| <b>Net cash provided by investing activities</b>   | <b>52,403</b>     | <b>22,978</b>    |
| Financing activities:  |                   |                  |
| Proceeds from sale of class A common stock under employee stock purchase plan and exercise of employee stock options | 2,919             | 7,158            |
| Excess tax benefits from stock-based payment arrangements  | 2,208             |                  |
| Purchases of treasury stock  | (131,959)         | (127,562)        |
| <b>Net cash used in financing activities</b>   | <b>(126,832)</b>  | <b>(120,404)</b> |
| Effect of foreign exchange rate changes on cash and cash equivalents   | 2,135             | (3,732)          |
| <b>Net increase (decrease) in cash and cash equivalents</b>  | <b>5,510</b>      | <b>(28,700)</b>  |
| Cash and cash equivalents, beginning of period   | 42,318            | 68,314           |
| <b>Cash and cash equivalents, end of period</b>  | <b>\$ 47,828</b>  | <b>\$ 39,614</b> |

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The accompanying notes are an integral part of these Consolidated Financial Statements.

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**MICROSTRATEGY INCORPORATED**

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(unaudited)

**(1) Basis of Presentation**

Except for the consolidated balance sheets of MicroStrategy Incorporated ( MicroStrategy or the Company ) as of December 31, 2005, which is derived from audited financial statements, the accompanying consolidated financial statements are unaudited. In the opinion of management, all adjustments necessary for a fair statement of such financial position and results of operations have been included. All such adjustments are of a normal recurring nature. Interim results are not necessarily indicative of results for a full year.

The consolidated financial statements and notes are presented as required by Form 10-Q and do not contain certain information included in the Company's annual financial statements and notes. These financial statements should be read in conjunction with the Company's audited financial statements and the notes thereto filed with the Securities and Exchange Commission ( SEC ) in the Company's Annual Report on Form 10-K for the year ended December 31, 2005.

Certain prior year amounts in the consolidated financial statements have been reclassified to conform to the current year presentation.

**(2) Recent Accounting Standards**

In September 2006, the SEC issued Staff Accounting Bulletin 108 ( SAB 108 ), Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements . SAB 108 provides interpretive guidance on how the effects of the carryover or reversal of prior year misstatements should be considered in quantifying a current year misstatement. The SEC staff believes that registrants should quantify errors using both a balance sheet and an income statement approach and evaluate whether either approach results in quantifying a misstatement that, when all relevant quantitative and qualitative factors are considered, is material. The guidance in SAB 108 must be applied to annual financial statements for fiscal years ending after November 15, 2006. The Company is currently assessing the impact of adopting SAB 108 but does not expect that it will have a material effect on its consolidated results of operations or financial position.

In June 2006, the Financial Accounting Standards Board ( FASB ) issued FASB Interpretation No. 48 ( FIN 48 ), Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109 . FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with Statement of Financial Accounting Standards ( SFAS ) No. 109, Accounting for Income Taxes . It prescribes that a company should use a more-likely-than-not recognition threshold based on the technical merits of the income tax position taken. Income tax positions that meet the more-likely-than-not recognition threshold should be measured in order to determine the tax benefit to be recognized in the financial statements. FIN 48 is effective in fiscal years beginning after December 15, 2006. The Company is currently evaluating the impact of FIN 48 on its consolidated results of operations and financial condition.

**(3) Restricted Cash and Investments**

On March 15, 2005, the Company entered into a security agreement with a bank under which the Company posted cash to secure existing letters of credit. These letters of credit are used as security deposits for office leases, including the office lease for the Company's corporate headquarters. The Company may invest the cash collateral under the security agreement in certain permitted investments. As of September 30, 2006 and December 31, 2005, the Company had \$2.8 and \$4.2 million, respectively, in cash collateral posted under the security agreement, all invested in money market funds that are included in restricted cash and investments in the accompanying balance sheets.

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## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(unaudited)

**(4) Accounts Receivable**

Accounts receivable, net of allowances, consisted of the following, as of (in thousands):

|  | September 30, | December 31, |
|--|---------------|--------------|
|  | 2006          | 2005         |
| Billed and billable                      | \$ 78,068     | \$ 86,974    |
| Less: billed and unpaid deferred revenue | (34,801)      | (42,407)     |
|  | 43,267        | 44,567       |
| Less: allowance for doubtful accounts    | (1,566)       | (1,515)      |
|  | \$ 41,701     | \$ 43,052    |

The Company offsets accounts receivable and deferred revenue for any billed and unpaid items included in deferred revenue and advance payments.

**(5) Investments**

As of December 31, 2005, the Company's investment balance in auction rate securities of varying maturities was \$53.7 million. As of September 30, 2006, all auction rate securities had been sold. There were no realized gains or losses on these investments recognized during the three and nine months ended September 30, 2006.

**(6) Deferred Revenue and Advance Payments**

Deferred revenue and advance payments from customers consisted of the following, as of (in thousands):

|  | September 30, | December 31, |
|--|---------------|--------------|
|  | 2006          | 2005         |
| <b>Current:</b>                          |               |              |
| Deferred product licenses revenue        | \$ 2,367      | \$ 2,990     |
| Deferred product support revenue         | 75,482        | 72,645       |
| Deferred other services revenue          | 13,484        | 11,780       |
|  | 91,333        | 87,415       |
| Less: billed and unpaid deferred revenue | (34,194)      | (41,541)     |
|  | \$ 57,139     | \$ 45,874    |
| <b>Non-current:</b>                      |               |              |
| Deferred product licenses revenue        | \$ 196        | \$ 174       |
| Deferred product support revenue         | 1,751         | 2,228        |

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|  |          |          |
|--|----------|----------|
| Deferred other services revenue          | 17       | 18       |
|  | 1,964    | 2,420    |
| Less: billed and unpaid deferred revenue | (607)    | (866)    |
|  | \$ 1,357 | \$ 1,554 |

The Company offsets accounts receivable and deferred revenue for any billed and unpaid items included in deferred revenue and advance payments.

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**MICROSTRATEGY INCORPORATED**

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(unaudited)

**(7) Litigation**

*(a) Business Objects Litigation*

On October 17, 2001, Business Objects filed suit against the Company in the United States District Court for the Northern District of California, claiming that the Company's software infringes a patent issued to Business Objects relating to relational database access (the 403 patent). The District Court granted the Company's motion for summary judgment and dismissed the lawsuit, ruling as a matter of law that its products do not infringe the 403 patent. On appeal, the United States Court of Appeals for the Federal Circuit ruled that the District Court had correctly construed the patent, that the Company does not literally infringe any of the asserted patent claims, and that Business Objects is legally barred from claiming that the Company's products infringe two of the three asserted claims under the doctrine of equivalents. On remand, the District Court granted the Company's motion for summary judgment of non-infringement for the one remaining patent claim and dismissed the lawsuit. On September 13, 2006, the Federal Circuit affirmed the District Court's ruling.

*(b) Other Matters*

In October 2006, a commercial court in Spain rendered a judgment against the Company for approximately \$1.1 million, plus interest and certain costs of the proceeding, in connection with a commercial dispute. The Company intends to appeal the ruling. Until final adjudication of the matter on appeal, the Company does not expect to make any cash payment specified in the decision or post a bond or other security. As a result of the court's decision, the Company recorded a liability of approximately \$1.1 million as of September 30, 2006.

The Company is also involved in other legal proceedings through the normal course of business. Management believes that any unfavorable outcome related to these other proceedings will not have a material effect on the Company's financial position, results of operations or cash flows.

**(8) Treasury Stock**

On July 28, 2005, the Company announced that its Board of Directors had authorized the Company's repurchase of up to an aggregate of \$300.0 million of its class A common stock from time to time on the open market (the 2005 Share Repurchase Program). The timing and amount of any shares repurchased will be determined by the Company's management based on its evaluation of market conditions and other factors. The 2005 Share Repurchase Program has a five-year term, but may be suspended or discontinued by the Company at any time. The 2005 Share Repurchase Program may be funded using the Company's working capital, as well as proceeds from any credit facilities and other borrowing arrangements which the Company may enter into in the future. During the three months ended September 30, 2006, the Company repurchased an aggregate of 215,440 shares of its class A common stock at an average price per share of \$88.89 and an aggregate cost of \$19.2 million pursuant to the 2005 Share Repurchase Program. During the nine months ended September 30, 2006, the Company repurchased an aggregate of 1,379,266 shares of its class A common stock at an average price of \$95.67 and an aggregate cost of \$132.0 million pursuant to the 2005 Share Repurchase Program.

On July 27, 2004, the Company announced that its Board of Directors had authorized the Company's repurchase of up to \$35.0 million of its class A common stock (the 2004 Share Repurchase Program). On April 26, 2005, the Company's Board of Directors modified the 2004 Share Repurchase Program to increase, from \$35.0 million to \$130.0 million, the aggregate amount of class A common stock that the Company is authorized to repurchase. During the second quarter of 2005, the Company repurchased under the 2004 Share Repurchase Program 2,509,952 shares of class A common stock at an average price per share of \$50.82 and an aggregate cost of \$127.6 million. Including repurchase activity from all prior periods, the Company repurchased an aggregate of 2,577,752 shares of class A common stock at an average price per share of \$50.39 and an aggregate cost of \$129.9 million under the 2004 Share Repurchase Program. Since repurchases under the 2004 Share Repurchase Program reached the aggregate authorized limit, the 2004 Share Repurchase Program was completed in the second quarter of 2005.

All of the amounts above relating to average price per share and aggregate cost include broker commissions.





**Table of Contents****MICROSTRATEGY INCORPORATED**

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(unaudited)

**(9) Income Taxes**

The following table summarizes the Company's deferred tax assets, net, and valuation allowance, as of (in thousands):

|  | September 30, | December 31, |
|--|---------------|--------------|
|  | 2006          | 2005         |
| Deferred tax assets, net of deferred tax liabilities | \$ 103,131    | \$ 117,494   |
| Valuation allowance                                  | (9,371)       | (8,130)      |
| Deferred tax assets, net of valuation allowance      | \$ 93,760     | \$ 109,364   |
| Short-term deferred tax assets, net                  | \$ 28,580     | \$ 22,971    |
| Long-term deferred tax assets, net                   | 65,180        | 86,393       |
| Total deferred tax assets, net                       | \$ 93,760     | \$ 109,364   |

The valuation allowance as of September 30, 2006 and December 31, 2005 relates to domestic capital loss carryforwards and certain foreign net operating loss carryforwards that the Company expects will expire unused.

As required under Accounting Principles Board ( APB ) Opinion No. 28, Interim Financial Reporting , the Company has estimated its annual effective tax rate for the full fiscal year 2006 and applied that rate to its income before income taxes in determining its provision for income taxes for the nine months ended September 30, 2006. For the nine months ended September 30, 2006 and 2005, the Company's consolidated annualized effective tax rate was 29.7% and 32.4%, respectively.

The annualized effective tax rate for the nine months ended September 30, 2005 included a tax expense related to the repatriation of foreign earnings under the special dividend repatriation provisions of the American Jobs Creation Act of 2004.

The Company intends to indefinitely reinvest the undistributed 2006 earnings of certain foreign subsidiaries. Accordingly, the annualized effective tax rate applied to our pre-tax income for the nine months ended September 30, 2006 did not include any provision for U.S. federal and state taxes on the projected amount of these undistributed 2006 foreign earnings. The Company accrues applicable U.S. federal and state taxes (net of foreign tax credits) on projected undistributed foreign subsidiary earnings that it intends to repatriate.

In determining our provision for income taxes, net deferred tax assets, liabilities and valuation allowances, management is required to make judgments and estimates related to projections of domestic and foreign profitability, the timing and extent of the utilization of both net operating loss carryforwards and capital loss carryforwards, applicable tax rates, transfer pricing methodologies and prudent and feasible tax planning strategies. As a multinational company, the Company is required to calculate and provide for estimated income tax liabilities for each of the tax jurisdictions in which it operates. This process involves estimating current tax obligations and exposures in each jurisdiction as well as making judgments regarding the future recoverability of deferred tax assets. Changes in the estimated level of annual pre-tax income, changes in tax laws particularly related to the utilization of net operating losses in various jurisdictions, and changes resulting from tax audits can all affect the overall effective income tax rate which, in turn, impacts the overall level of income tax expense and net income.

Judgments and estimates related to the Company's projections and assumptions are inherently uncertain; therefore, actual results could differ materially from projections. The timing and manner in which the Company will utilize the net operating loss carryforwards, research and development tax credit carryforward tax assets, alternative minimum tax credit carryforward tax assets, and foreign tax credit carryforward tax assets in any year, or in total, may be limited by provisions of the Internal Revenue Code regarding changes in the Company's ownership. Currently, the Company expects to use the tax assets subject to Internal Revenue Code limitations within the carryforward period.



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**MICROSTRATEGY INCORPORATED**

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(unaudited)

**(10) Share-Based Compensation**

The Company adopted SFAS No. 123R, as of January 1, 2006 using the modified prospective method. Under the modified prospective method, the Company has not restated its prior period financial statements for the related share-based compensation amounts. The Company has applied SFAS No. 123R for any portion of awards that were granted and have not fully vested prior to December 31, 2005. The Company will apply SFAS No. 123R to all new awards granted after January 1, 2006.

Prior to adoption of SFAS No. 123R, the Company used the graded vesting method for determining compensation expense, and has carried that method over and continues to apply the graded vesting method for any portion of awards that were granted and have not fully vested prior to December 31, 2005. Upon adoption of SFAS No. 123R on January 1, 2006, the Company elected the straight-line method for any share-based awards that may be granted subsequent to adoption.

Since the adoption of SFAS No. 123R and through September 30, 2006, the Company has not granted any new share-based awards. In addition, the Company has not issued any material stock option or other share-based compensation awards since the first quarter of 2004.

SFAS No. 123R eliminates the intrinsic value method that was previously used by the Company as an alternative method of accounting for share-based awards. SFAS No. 123R also clarifies earlier guidance in several areas, including measuring fair value, classifying an award as equity or as a liability and attributing compensation cost to reporting periods. In addition, SFAS No. 123R amends SFAS No. 95, Statement of Cash Flows, to require that excess tax benefits be reported as a financing cash inflow and a reduction of taxes paid within operating cash flows.

The Company has share-based compensation plans under which directors, officers, and other eligible employees have previously received stock options awards. All stock options granted under the Company's stock plans have terms of five to ten years and generally vest ratably over 5 years. Upon exercise, the Company generally issues new shares in the amount of the award exercised. The Company had 2.3 million shares of class A common stock authorized for option grants as of September 30, 2006.

In addition, a subsidiary of the Company maintains a share-based compensation plan for its employees that is based upon the equity of the subsidiary. The share-based awards and related expense under SFAS No. 123R for this subsidiary have not been material through September 30, 2006.

The fair value of each grant has been estimated using the Black-Scholes option-valuation model, and the related compensation expense is amortized over the requisite service period (generally the vesting period) using the graded-vesting method that recognizes compensation cost for each separately vesting tranche of the award as though the award were, in substance, multiple awards. During the three months ended September 30, 2006, the Company recorded total share-based compensation of \$0.3 million and an immaterial amount of related income tax benefits in the Consolidated Statement of Operations. During the nine months ended September 30, 2006, the Company recorded total share-based compensation of \$1.1 million and an immaterial amount of related income tax benefits in the Consolidated Statement of Operations. No compensation cost was capitalized as part of the cost of an asset.

On May 26, 2006, the Company's Board of Directors approved an amendment to the stock option granted on June 7, 2001 to F. David Fowler, a member of the Company's Board of Directors until his retirement from the Board on May 31, 2006. The option provided Mr. Fowler the right to purchase an aggregate of 10,000 shares of the Company's class A common stock (the Award), vesting in five equal annual installments beginning on the first anniversary of the grant date. The amendment provided that the final 2,000 share installment of the Award, which was scheduled to vest on June 7, 2006, instead vested in full as

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of May 26, 2006. On May 26, 2006 the Company recognized \$0.1 million in share-based compensation to reflect the amendment of this Award. All other terms and conditions applicable to the stock option remain unchanged.

The Company's share-based compensation expense is included in the following areas in the Consolidated Statement of Operations for the periods indicated (in thousands):

|   | <b>Three Months Ended</b> | <b>Nine Months Ended</b> |
|---|---------------------------|--------------------------|
|   | <b>September 30,</b>      | <b>September 30,</b>     |
|   | <b>2006</b>               | <b>2006</b>              |
| Cost of services                              | \$ 4                      | \$ 14                    |
| Sales and marketing                           | 59                        | 237                      |
| Research and development                      | 44                        | 155                      |
| General and administrative                    | 157                       | 680                      |
| <b>Total share-based compensation expense</b> | <b>\$ 264</b>             | <b>\$ 1,086</b>          |

For the three and nine months ended September 30, 2005, the Company measured compensation expense relating to share-based compensation using the intrinsic value method allowed at the time. Based on this method, no share-based compensation cost is reflected in net income during the three and nine months ended September 30, 2005. If compensation expense had been recorded based on the fair value of awards, the Company's net income would have been adjusted to equal the pro forma amounts presented below for the periods indicated (in thousands, except per share data):

|   | <b>Three Months Ended</b> | <b>Nine Months Ended</b> |
|---|---------------------------|--------------------------|
|   | <b>September 30,</b>      | <b>September 30,</b>     |
|   | <b>2005</b>               | <b>2005</b>              |
| Net income, as reported   | \$ 13,253                 | \$ 45,893                |
| Stock-based employee compensation expense under fair value based method, net of tax (1) | (373)                     | (1,929)                  |
| <b>Pro forma net income</b>   | <b>\$ 12,880</b>          | <b>\$ 43,964</b>         |
| Basic earnings per share, as reported   | \$ 0.96                   | \$ 3.05                  |
| <b>Diluted earnings per share, as reported</b>  | <b>\$ 0.91</b>            | <b>\$ 2.91</b>           |
| Basic earnings per share, pro forma   | \$ 0.93                   | \$ 2.92                  |
| <b>Diluted earnings per share, pro forma</b>  | <b>\$ 0.89</b>            | <b>\$ 2.79</b>           |

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- (1) The pro forma stock-based employee compensation expense related to the three and nine months ended September 30, 2005, as presented above, is subsequent to the release of substantially all of the valuation allowance (see Note 9) and is shown net of tax effect of \$228,000 and \$1.2 million, respectively, using a combined domestic federal and state effective tax rate of 37.7% in the first and second quarters of 2005 and 38.0% in the third quarter of 2005.

At September 30, 2006, the total compensation cost of nonvested awards not yet recognized was \$1.0 million, which is expected to be recognized over the next 3 years. The windfall tax benefits realized from the exercise of stock options was not material during the three months ended September 30, 2006. The windfall tax benefits realized from the exercise of stock options was \$2.2 million during the nine months ended September 30, 2006.

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A summary of the status of MicroStrategy's share-based compensation plans is presented below for the periods indicated (in thousands, except per share data, and excluding immaterial share-based awards that were awarded by a subsidiary of the Company):

|                             | Shares | Options Outstanding<br>Price per Share |            | Weighted<br>Average | Aggregate<br>Intrinsic<br>Value (1) | Number<br>of Shares | Options Exercisable                   |                                     |
|-----------------------------|--------|--|------------|---------------------|-------------------------------------|---------------------|---------------------------------------|-------------------------------------|
|                             |        | Range                                  |            |                     |                                     |                     | Weighted<br>Average<br>Exercise Price | Aggregate<br>Intrinsic<br>Value (1) |
| Balance, December 31, 2005  | 1,559  | \$ 2.50                                | - 3,130.00 | \$ 90.22            |                                     | 919                 | \$ 138.52                             |                                     |
| Granted                     |        | \$ -                                   |            | \$ -                |                                     |                     |                                       |                                     |
| Exercised                   | (104)  | \$ 2.50                                | - 83.44    | \$ 22.83            |                                     |                     |                                       |                                     |
| Canceled                    | (8)    | \$ 11.91                               | - 1,042.50 | \$ 82.52            |                                     |                     |                                       |                                     |
| Balance, March 31, 2006     | 1,447  | \$ 2.50                                | - 3,130.00 | \$ 95.11            | \$ 93,303                           | 1,002               | \$ 128.56                             | \$ 55,253                           |
| Granted                     |        | \$ -                                   |            | \$ -                |                                     |                     |                                       |                                     |
| Exercised                   | (18)   | \$ 5.63                                | - 83.44    | \$ 20.91            |                                     |                     |                                       |                                     |
| Canceled                    | (5)    | \$ 12.37                               | - 1,698.75 | \$ 324.71           |                                     |                     |                                       |                                     |
| Balance, June 30, 2006      | 1,424  | \$ 2.50                                | - 3,130.00 | \$ 95.29            | \$ 83,137                           | 988                 | \$ 128.72                             | \$ 49,111                           |
| Granted                     |        | \$ -                                   |            | \$ -                |                                     |                     |                                       |                                     |
| Exercised                   | (7)    | \$ 12.37                               | - 30.00    | \$ 22.60            |                                     |                     |                                       |                                     |
| Canceled                    | (37)   | \$ 11.91                               | - 1,698.75 | \$ 57.10            |                                     |                     |                                       |                                     |
| Balance, September 30, 2006 | 1,380  | \$ 2.50                                | - 3,130.00 | \$ 96.96            | \$ 84,615                           | 1,023               | \$ 123.43                             | \$ 55,804                           |

(1) The intrinsic value of an option represents the amount by which the market value of the stock exceeds the exercise price of the option of in-the-money options only. The aggregate intrinsic value is based on the closing price of \$105.29, \$97.52, and \$101.83 for the Company's stock on the NASDAQ on March 31, 2006, June 30, 2006, and September 30, 2006, respectively.

At September 30, 2006, the Company's 1.4 million outstanding stock options (including fully vested options and options that are expected to vest) had a weighted average remaining contractual term of 5.1 years; and its 1.0 million outstanding and exercisable stock options had a weighted average remaining contractual term of 4.6 years.

**(11) Comprehensive Income**

Comprehensive income includes foreign currency translation adjustments and unrealized gains and losses on short-term investments, net of related tax effects that have been excluded from net income and reflected in stockholders' equity as accumulated other comprehensive income.

The Company's comprehensive income consisted of the following for the periods indicated (in thousands):

|  | Three Months Ended |                    | Nine Months Ended  |                    |
|--|--------------------|--------------------|--------------------|--------------------|
|  | September 30, 2006 | September 30, 2005 | September 30, 2006 | September 30, 2005 |
| Net income   | \$ 16,972          | \$ 13,253          | \$ 48,523          | \$ 45,893          |
| Foreign currency translation adjustment                            | (622)              | 354                | (224)              | (926)              |
| Unrealized gain on short-term investments, net of applicable taxes | (7)                |                    | (20)               |                    |
| Comprehensive income   | \$ 16,343          | \$ 13,607          | \$ 48,279          | \$ 44,967          |

**(12) Common Equity and Earnings per Share**

The Company has two classes of common stock: class A common stock and class B common stock. Holders of class A common stock generally have the same rights, including rights to dividends, as holders of class B common stock, except that holders of class A common stock have one vote per share while holders of class B common stock have ten votes per share. Each share of class B common stock is convertible at any time, at the option of the holder, into one share of class A common stock. As such, basic and fully diluted earnings per share for class A and class B common stock are the same. The Company has never declared or paid any cash dividends on either class A or class B common stock.

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Potential common shares are included in the diluted earnings per share calculation when dilutive. Potential common shares consisting of common stock issuable upon exercise of outstanding employee stock options and warrants are computed using the treasury stock method.

**(13) Segment Information**

The Company operates in one operating segment – business intelligence. The Company’s total revenues and long-lived assets, excluding long-term investments and long-term deferred tax assets, consisted of the following according to geographic region for the periods indicated (in thousands):

|  | Domestic   | International | Consolidated |
|--|------------|---------------|--------------|
| <b>Three Months Ended September 30, 2006</b> |            |               |              |
| Total licenses and services revenues         | \$ 49,126  | \$ 28,539     | \$ 77,665    |
| Long-lived assets                            | 11,564     | 3,576         | 15,140       |
| <b>Three Months Ended September 30, 2005</b> |            |               |              |
| Total licenses and services revenues         | \$ 41,608  | \$ 24,202     | \$ 65,810    |
| Long-lived assets                            | 16,653     | 2,967         | 19,620       |
| <b>Nine Months Ended September 30, 2006</b>  |            |               |              |
| Total licenses and services revenues         | \$ 140,048 | \$ 81,221     | \$ 221,269   |
| Long-lived assets                            | 11,564     | 3,576         | 15,140       |
| <b>Nine Months Ended September 30, 2005</b>  |            |               |              |
| Total licenses and services revenues         | \$ 119,192 | \$ 72,041     | \$ 191,233   |
| Long-lived assets                            | 16,653     | 2,967         | 19,620       |

The domestic region consists of the United States and Canada. The international region consists of all other countries. Domestic intercompany software fee charges to international operations of \$12.5 million and \$10.6 million for the three months ended September 30, 2006 and 2005, respectively, and \$32.9 million and \$30.8 million for the nine months ended September 30, 2006 and 2005, respectively, have been excluded from the above tables and eliminated in the consolidated financial statements.

For the three and nine months ended September 30, 2006, no individual country outside the United States accounted for 10% or more of total consolidated revenues. For the three and nine months ended September 30, 2005, no individual country outside the United States accounted for 10% or more of total consolidated revenues.

As of September 30, 2006, Germany accounted for 10% of consolidated assets. As of December 31, 2005, no individual country outside the United States accounted for 10% or more of consolidated assets.

For the three and nine months ended September 30, 2006, no individual customer accounted for 10% or more of the Company’s total consolidated revenues. For the three and nine months ended September 30, 2005, no individual customer accounted for 10% or more of the Company’s total consolidated revenues.



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

**FORWARD-LOOKING INFORMATION**

This Quarterly Report on Form 10-Q contains forward-looking statements within the meaning of Section 21E of the Securities Exchange Act of 1934, as amended. For this purpose, any statements contained herein that are not statements of historical fact, including without limitation, certain statements regarding industry prospects and our results of operations or financial position, may be deemed to be forward-looking statements. Without limiting the foregoing, the words believes, anticipates, plans, expects, and similar expressions are intended to identify forward-looking statements. The important factors discussed below under Item 1A. Risk Factors, among others, could cause actual results to differ materially from those indicated by forward-looking statements made herein. Such forward-looking statements represent management's current expectations and are inherently uncertain. Investors are warned that actual results may differ from management's expectations.

**Overview**

We are a worldwide provider of business intelligence software that enables companies to analyze the raw data stored across their enterprise to reveal the trends and insights needed to develop solutions to manage their business effectively. Our software delivers this information to workgroups, the enterprise and extranet communities via e-mail, web, fax, wireless and voice communication channels. Businesses can use our software platform to develop user-friendly solutions, proactively refine revenue-generating strategies, enhance cost-efficiency and productivity and improve customer relationships.

The MicroStrategy software platform enables users to query and analyze the most detailed, transaction-level databases, turning data into business intelligence and delivering boardroom quality reports and alerts about the users' business processes. Our web-based architecture provides reporting, security, performance and standards that are critical for web deployment. With intranet deployments, our products provide employees with information to enable them to make better, more cost-effective business decisions. With extranet deployments, enterprises can use the MicroStrategy software platform to build stronger relationships by linking customers and suppliers via the Internet. We also offer a comprehensive set of consulting, education, technical support and technical advisory services for our customers and strategic partners.

We derive our revenues from product licenses and product support and other services. Product licenses revenues are derived from the sale of software licenses for our MicroStrategy 8 business intelligence platform and related products. We license our software to end users through our direct sales organization and through indirect sales channels, such as resellers, systems integrators and original equipment manufacturers, or OEMs. Our arrangements with customers typically include: (a) an end-user license fee paid for the use of our products in perpetuity or over a specified term; (b) an annual maintenance agreement that provides for software updates and upgrades and technical support for an annual fee; and (c) a services work order for implementation, consulting and training, generally for a fee determined on a time-and-materials basis or, in certain circumstances, a fixed-fee.

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We earned net income of \$17.0 million and \$48.5 million in the three and nine months ended September 30, 2006, respectively, compared to \$13.3 million and \$45.9 million in the three and nine months ended September 30, 2005, respectively. The following are some operating highlights for the three months ended September 30, 2006 compared to the three months ended September 30, 2005:

| Quarterly Performance Measures (in thousands) | Three Months Ended    |                       |              |
|---|-----------------------|-----------------------|--------------|
|   | September 30,<br>2006 | September 30,<br>2005 | % Change     |
| <b>Revenues:</b>                              |                       |                       |              |
| Product licenses revenues                     | \$ 24,494             | \$ 22,608             | 8.3%         |
| Product support revenues                      | 36,916                | 29,427                | 25.4%        |
| Other services revenues                       | 16,255                | 13,775                | 18.0%        |
| <b>Total revenues</b>                         | <b>\$ 77,665</b>      | <b>\$ 65,810</b>      | <b>18.0%</b> |
| Cost of revenues                              | \$ 11,709             | \$ 9,279              | 26.2%        |
| <b>Gross Profit</b>                           | <b>\$ 65,956</b>      | <b>\$ 56,531</b>      | <b>16.7%</b> |
| <b>Operating Expenses:</b>                    |                       |                       |              |
| Sales and marketing                           | \$ 21,518             | \$ 16,652             | 29.2%        |
| Research and development                      | 8,794                 | 7,820                 | 12.5%        |
| General and administrative                    | 12,469                | 9,179                 | 35.8%        |
| Amortization of intangible assets             | 18                    | 18                    | 0.0%         |
| <b>Total operating expenses</b>               | <b>\$ 42,799</b>      | <b>\$ 33,669</b>      | <b>27.1%</b> |
| <b>Income from Operations</b>                 | <b>\$ 23,157</b>      | <b>\$ 22,862</b>      | <b>1.3%</b>  |

The business intelligence market is highly competitive and our results of operations depend on our ability to market and sell product offerings that provide customers with greater value than those offered by our competitors. Organizations recently have sought, and we expect will continue to seek, to standardize their various business intelligence applications around a single software platform. This trend presents both opportunities and risks for our business, as it offers us the opportunity to increase the size of transactions with new customers and to expand the size of our business intelligence installations with existing customers, while on the other hand creating risks that we may not be able to penetrate accounts where a competitor currently is or may become the incumbent business intelligence application provider. In addition, companies with industry leading positions in certain software markets, such as Microsoft and Oracle, have begun incorporating certain business intelligence capabilities into their product suites. As a result, our products need to be sufficiently differentiated from these bundled software offerings to create customer demand for our platform and products.

To address these opportunities and challenges, we are implementing a number of initiatives, including:

focusing our research and development efforts on maintaining our position as a technology leader, with our products capable of efficiently handling the largest customer databases, and incorporating new product features to our dashboard style customer interfaces; and

adding new leadership to our global team, increasing our capacity to develop new business, expanding relationships with customers and strengthening our corporate infrastructure.

We base our operating expense budgets on expected revenue trends. Many of our expenses, such as office leases and certain personnel costs, are relatively fixed. We may be unable to adjust spending quickly enough in any particular period to offset any unexpected revenue shortfall in that period. Accordingly, any shortfall in revenue may cause significant variation in our operating results. We therefore believe that quarter-to-quarter comparisons of our operating results may not be a good indication of our future performance.

**Critical Accounting Policies**

Our discussion and analysis of our financial condition and results of operations are based upon our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States.

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The preparation of our consolidated financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities and equity 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. These estimates, particularly estimates relating to revenue recognition, valuation of net deferred tax assets, litigation and contingencies, have a material impact on our financial statements and are discussed in detail throughout our analysis of the results of operations discussed below.

In addition to evaluating estimates relating to the items discussed above, we also consider other estimates and judgments, including, but not limited to, those related to allowance for doubtful accounts, software development costs, intangible assets, provision for income taxes, and other contingent liabilities. We base our estimates on historical experience and various other assumptions that we believe are reasonable under the circumstances, the results of which form the basis for making judgments about the carrying value of assets, liabilities and equity that are not readily apparent from other sources. Actual results and outcomes could differ from these estimates and assumptions.

MicroStrategy does not have any material ownership interest in any special purpose or other entities that are not wholly-owned and/or consolidated into our consolidated financial statements. Additionally, MicroStrategy does not have any material related party transactions as defined under Statement of Financial Accounting Standards ( SFAS ) No. 57, Related Party Disclosures.

For a more detailed explanation of the judgments made in these areas and a discussion of our accounting policies, refer to Critical Accounting Policies included in Item 7 and Summary of Significant Accounting Policies (Note 2) included in Item 15 of our Annual Report on Form 10-K for the year ended December 31, 2005. Since December 31, 2005, there have been no significant changes to our critical accounting policies.

**Results of Operations****Comparison of the three and nine months ended September 30, 2006 and 2005****Revenues**

**Product licenses revenues.** The following table sets forth product licenses revenues (in thousands) and percentage changes for the periods indicated:

|                                 | Three Months Ended    |                       |             | Nine Months Ended     |                       |             |
|---------------------------------|-----------------------|-----------------------|-------------|-----------------------|-----------------------|-------------|
|                                 | September 30,<br>2006 | September 30,<br>2005 | %<br>Change | September 30,<br>2006 | September 30,<br>2005 | %<br>Change |
| Product Licenses Revenues:      |                       |                       |             |                       |                       |             |
| Domestic (U.S. and Canada)      | \$ 15,611             | \$ 14,589             | 7.0%        | \$ 45,095             | \$ 44,133             | 2.2%        |
| International                   | 8,883                 | 8,019                 | 10.8%       | 25,643                | 24,541                | 4.5%        |
| Total product licenses revenues | \$ 24,494             | \$ 22,608             | 8.3%        | \$ 70,738             | \$ 68,674             | 3.0%        |

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|   | Three Months                |          | Nine Months                 |           |
|---|-----------------------------|----------|-----------------------------|-----------|
|   | Ended September 30,<br>2006 | 2005     | Ended September 30,<br>2006 | 2005      |
| <b>Product Licenses Transactions with Recognized Licenses Revenue in the Applicable Period:</b> |                             |          |                             |           |
| At least \$1.0 million of licenses revenue recognized   | 5                           | 4        | 12                          | 9         |
| Between \$500,000 and \$1.0 million of licenses revenue recognized                              | 3                           | 2        | 12                          | 15        |
| <b>Total</b>  | <b>8</b>                    | <b>6</b> | <b>24</b>                   | <b>24</b> |
| <b>Domestic:</b>  |                             |          |                             |           |
| At least \$1.0 million of licenses revenue recognized   | 3                           | 3        | 8                           | 7         |
| Between \$500,000 and \$1.0 million of licenses revenue recognized                              | 3                           | 2        | 9                           | 14        |
| <b>Total</b>  | <b>6</b>                    | <b>5</b> | <b>17</b>                   | <b>21</b> |
| <b>International:</b>   |                             |          |                             |           |
| At least \$1.0 million of licenses revenue recognized   | 2                           | 1        | 4                           | 2         |
| Between \$500,000 and \$1.0 million of licenses revenue recognized                              | 0                           | 0        | 3                           | 1         |
| <b>Total</b>  | <b>2</b>                    | <b>1</b> | <b>7</b>                    | <b>3</b>  |

Product licenses revenues increased during the three months ended September 30, 2006, as compared to the same period in the prior year, due to increases in both the number and the average deal size of product licenses transactions with greater than \$500,000 of recognized revenue.

Product licenses revenues increased during the nine months ended September 30, 2006, as compared to the same period in the prior year, due to an increase in the total number of product licenses transactions with at least \$1.0 million of recognized revenue.

**Domestic product licenses revenues.** Domestic product licenses revenues increased during the three months ended September 30, 2006, as compared to the same period in the prior year, due to an increase in the average deal size of domestic transactions with greater than \$500,000 of recognized revenue and an increase in the number of domestic transactions with between \$500,000 and \$1.0 million of recognized revenue. During the nine months ended September 30, 2006, domestic product licenses revenues increased, as compared to the same period in the prior year, due to increases in both the number and the average deal size of domestic transactions with at least \$1.0 million of recognized revenue.

**International product licenses revenues.** International product licenses revenues increased during the three months ended September 30, 2006, as compared to the same period in the prior year, due to an increase in the number of international transactions with at least \$1.0 million of recognized revenue. During the nine months ended September 30, 2006, international product licenses revenues increased, as compared to the same period in the prior year, due to an increase in the number of international transactions with greater than \$500,000 of recognized revenue.

International product licenses revenues were affected by favorable foreign currency fluctuations of 4.6% during the three months ended September 30, 2006, as compared to the same period in the prior year, and by favorable foreign currency fluctuations of 1.7% during the three months ended September 30, 2005, as compared to the same period in the prior year. International product licenses revenues were affected by unfavorable foreign currency fluctuations of 1.3% during the nine months ended September 30, 2006, as compared to the same period in the prior year, and by favorable foreign currency fluctuations of 3.4% during the nine months ended September 30, 2005, as compared to the same period in the prior year.

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**Product support revenues.** The following table sets forth product support revenues (in thousands) and percentage changes for the periods indicated:

|                                  | Three Months Ended |                    |        | Nine Months Ended  |                    |        |
|----------------------------------|--------------------|--------------------|--------|--------------------|--------------------|--------|
|                                  |                    |                    | %      |                    |                    | %      |
|                                  | September 30, 2006 | September 30, 2005 | Change | September 30, 2006 | September 30, 2005 | Change |
| <b>Product Support Revenues:</b> |                    |                    |        |                    |                    |        |
| Domestic (U.S. and Canada)       | \$ 21,727          | \$ 18,011          | 20.6%  | \$ 61,824          | \$ 50,893          | 21.5%  |
| International                    | 15,189             | 11,416             | 33.1%  | 41,578             | 33,374             | 24.6%  |
| Total product support revenues   | \$ 36,916          | \$ 29,427          | 25.4%  | \$ 103,402         | \$ 84,267          | 22.7%  |

Product support revenues are derived from providing technical software support and software updates and upgrades to customers. Product support revenues are recognized ratably over the term of the contract, which in most cases is one year.

Both domestic and international product support revenues increased during the three months ended September 30, 2006, as compared to the same period in the prior year. Contributing to the increase was a 21.5% growth in our installed base of technical support contracts which includes a high percentage of maintenance renewals from existing contracts.

Both domestic and international product support revenues increased during the nine months ended September 30, 2006, as compared to the same period in the prior year. Contributing to the increase was a 22.7% growth in our installed base of technical support contracts which includes a high percentage of maintenance renewals from existing contracts.

International product support revenues was affected by favorable foreign currency fluctuations of 4.7% during the three months ended September 30, 2006, as compared to the same period in the prior year, and by favorable foreign currency fluctuations of 2.1% during the three months ended September 30, 2005, as compared to the same period in the prior year. International product support revenues was affected by unfavorable foreign currency fluctuations of 0.7% during the nine months ended September 30, 2006, as compared to the same period in the prior year, and by favorable foreign currency fluctuations of 4.7% during the nine months ended September 30, 2005, as compared to the same period in the prior year.

**Other services revenues.** The following table sets forth other services revenues (in thousands) and percentage changes for the periods indicated:

|                                 | Three Months Ended |                    |        | Nine Months Ended  |                    |        |
|---------------------------------|--------------------|--------------------|--------|--------------------|--------------------|--------|
|                                 |                    |                    | %      |                    |                    | %      |
|                                 | September 30, 2006 | September 30, 2005 | Change | September 30, 2006 | September 30, 2005 | Change |
| <b>Other Services Revenues:</b> |                    |                    |        |                    |                    |        |
|                                 | \$ 16,255          | \$ 13,775          | 18.0%  | \$ 47,129          | \$ 38,292          | 23.1%  |

Other services revenues include revenues from consulting to help customers plan and execute the deployment of our software. Other services revenues also include revenues from education and training, which we provide to our customers to enhance their ability to fully utilize the features and functionality of our software. In addition, other services revenues include revenue from our non-core businesses, Angel.com and Alarm.com, in the aggregate amounts of \$2.1 million and \$1.1 million for the three months ended September 30, 2006 and 2005, respectively, and \$5.7 million and \$2.5 million for the nine months ended September 30, 2006 and 2005, respectively.

Consulting revenues increased 16.6% during the three months ended September 30, 2006, as compared to the same period in the prior year, primarily due to an increase in the number of billable systems integration hours provided to our customers.

Consulting revenues increased 18.9% during the nine months ended September 30, 2006, as compared to the same period in the prior year, due to a 30.0% increase in the number of billable systems integration hours provided to our customers, partially offset by a decline in our international technical advisory services revenue.



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Education revenues were flat during the three months ended September 30, 2006, as compared to the same period in the prior year.

Education revenues increased 6.3% during the nine months ended September 30, 2006, as compared to the same period in the prior year, primarily due to growth in the number of students trained.

Other services revenues was affected by favorable foreign currency fluctuations of 1.2% during the three months ended September 30, 2006, as compared to the same period in the prior year, and by favorable foreign currency fluctuations of 1.1% during the three months ended September 30, 2005, as compared to the same period in the prior year. Other services revenues was affected by unfavorable foreign currency fluctuations of 0.3% during the nine months ended September 30, 2006, as compared to the same period in the prior year, and by favorable foreign currency fluctuations of 1.3% during the nine months ended September 30, 2005, as compared to the same period in the prior year.

**Costs and Expenses**

**Cost of revenues.** The following table sets forth cost of revenues (in thousands) and percentage changes in cost of revenues for the periods indicated:

|                        | Three Months Ended |                    |          | Nine Months Ended  |                    |          |
|------------------------|--------------------|--------------------|----------|--------------------|--------------------|----------|
|                        | September 30, 2006 | September 30, 2005 | % Change | September 30, 2006 | September 30, 2005 | % Change |
| Cost of Revenues:      |                    |                    |          |                    |                    |          |
| Product licenses       | \$ 826             | \$ 867             | -4.7%    | \$ 2,122           | \$ 3,062           | -30.7%   |
| Product support        | 2,325              | 2,050              | 13.4%    | 6,638              | 6,024              | 10.2%    |
| Other services         | 8,558              | 6,362              | 34.5%    | 23,114             | 17,983             | 28.5%    |
| Total cost of revenues | \$ 11,709          | \$ 9,279           | 26.2%    | \$ 31,874          | \$ 27,069          | 17.8%    |

**Cost of product licenses revenues.** Cost of product licenses revenues consists of amortization of capitalized software development costs and the costs of product manuals, media, and royalties paid to third-party software vendors. Capitalized software development costs are amortized over a useful life of three years.

Cost of product licenses revenues decreased during the three and nine months ended September 30, 2006, with 100% and 62.1% of the decreases, respectively, attributable to the fact that several of our products for which we recognized amortization expense during the three and nine months ended September 30, 2005 were fully amortized prior to 2006. The balance of the decrease for the nine months ended September 30, 2006 was due to a decline in royalties paid.

**Cost of product support revenues.** Cost of product support revenues consists of product support personnel and related overhead costs.

Cost of product support revenues increased during the three and nine months ended September 30, 2006, as compared to the same periods in the prior year, due primarily to an increase in staffing levels to support our larger customer base.

Cost of product support revenues was affected by unfavorable foreign currency fluctuations of 1.1% during the three months ended September 30, 2006, as compared to the same period in the prior year, and by unfavorable foreign currency fluctuations of 0.3% during the three months ended September 30, 2005, as compared to the same period in the prior year. Cost of product support revenues was affected by favorable foreign currency fluctuations of 0.1% during the nine months ended September 30, 2006, as compared to the same period in the prior year, and by unfavorable foreign currency fluctuations of 0.8% during the nine months ended September 30, 2005, as compared to the same period in the prior year.



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**Cost of other services revenues.** Cost of other services revenues consists of consulting and education personnel and related overhead costs. In addition, cost of other services revenues includes costs of revenue from our non-core businesses, Angel.com and Alarm.com, in the aggregate amounts of \$1.0 million and \$0.7 million for the three months ended September 30, 2006 and 2005, respectively, and \$2.6 million and \$1.4 million for the nine months ended September 30, 2006 and 2005, respectively.

The increase in cost of other services revenues during the three and nine months ended September 30, 2006, as compared to the same periods in the prior year, was primarily attributable to an increase in staffing levels to support our larger customer base.

Cost of other services revenues was affected by unfavorable foreign currency fluctuations of 1.6% during the three months ended September 30, 2006, as compared to the same period in the prior year, and by favorable foreign currency fluctuations of 0.1% during the three months ended September 30, 2005, as compared to the same period in the prior year. Cost of other services revenues was affected by favorable foreign currency fluctuations of 0.2% during the nine months ended September 30, 2006, as compared to the same period in the prior year, and by unfavorable foreign currency fluctuations of 1.2% during the nine months ended September 30, 2005, as compared to the same period in the prior year.

**Operating expenses.** The following table sets forth operating expenses (in thousands) and percentage changes in operating expenses for the periods indicated:

|                                   | Three Months Ended |                    |          | Nine Months Ended  |                    |          |
|-----------------------------------|--------------------|--------------------|----------|--------------------|--------------------|----------|
|                                   | September 30, 2006 | September 30, 2005 | % Change | September 30, 2006 | September 30, 2005 | % Change |
| Operating expenses:               |                    |                    |          |                    |                    |          |
| Sales and marketing               | \$ 21,518          | \$ 16,652          | 29.2%    | \$ 61,800          | \$ 50,419          | 22.6%    |
| Research and development          | 8,794              | 7,820              | 12.5%    | 25,776             | 23,099             | 11.6%    |
| General and administrative        | 12,469             | 9,179              | 35.8%    | 33,935             | 26,304             | 29.0%    |
| Amortization of intangible assets | 18                 | 18                 | 0.0%     | 53                 | 54                 | -1.9%    |
| Total operating expenses          | \$ 42,799          | \$ 33,669          | 27.1%    | \$ 121,564         | \$ 99,876          | 21.7%    |

**Sales and marketing expenses.** Sales and marketing expenses consists of personnel costs, commissions, office facilities, travel, advertising, public relations programs and promotional events, such as trade shows, seminars and technical conferences.

Sales and marketing expenses increased during the three months ended September 30, 2006, as compared to the same period in the prior year, with 62.1% of the increase due to an increase in staffing levels and compensation costs and the balance primarily due to increases in travel and entertainment to expand our footprint both domestically and internationally.

Sales and marketing expenses increased during the nine months ended September 30, 2006, as compared to the same period in the prior year, with 70.4% of the increase due to an increase in staffing levels and compensation costs and the balance primarily due to increases in travel and entertainment.

Sales and marketing expenses was affected by unfavorable foreign currency fluctuations of 1.7% during the three months ended September 30, 2006, as compared to the same period in the prior year, and by unfavorable foreign currency fluctuations of 0.8% during the three months ended September 30, 2005, as compared to the same period in the prior year. Sales and marketing expenses was affected by favorable foreign currency fluctuations of 0.4% during the nine months ended September 30, 2006, as compared to the same period in the prior year, and by unfavorable foreign currency fluctuations of 1.1% during the nine months ended September 30, 2005, as compared to the same period in the prior year.

**Research and development expenses.** Research and development expenses consists of the personnel costs for our software engineering personnel, depreciation of equipment and other related costs.

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The following table summarizes research and development expenses and amortization of capitalized software development costs (in thousands) for the periods indicated:

|  | Three Months Ended    |                 |              | Nine Months Ended     |                  |              |
|--|-----------------------|-----------------|--------------|-----------------------|------------------|--------------|
|  |                       |                 | %            |                       |                  | %            |
|  | September 30,<br>2006 | 2005            | Change       | September 30,<br>2006 | 2005             | Change       |
| <b>Gross research and development expenses:</b>  |                       |                 |              |                       |                  |              |
| Core research and development activities   | \$ 7,962              | \$ 7,303        | 9.0%         | \$ 23,721             | \$ 22,611        | 4.9%         |
| Non-core research and development activities   | 832                   | 517             | 60.9%        | 2,055                 | 1,414            | 45.3%        |
| Capitalized software development costs   |                       |                 | 0.0%         |                       | (926)            | 0.0%         |
| <b>Total research and development expenses</b>   | <b>\$ 8,794</b>       | <b>\$ 7,820</b> | <b>12.5%</b> | <b>\$ 25,776</b>      | <b>\$ 23,099</b> | <b>11.6%</b> |
| Amortization of capitalized software development costs included in cost of product licenses revenues |                       |                 |              |                       |                  |              |
|  | \$ 531                | \$ 575          | -7.7%        | \$ 1,592              | \$ 2,176         | -26.8%       |

Research and development expenses increased during the three months ended September 30, 2006, as compared to the same period in the prior year, due primarily to an increase in staffing, particularly in our non-core businesses.

Research and development expenses increased during the nine months ended September 30, 2006, as compared to the same period in the prior year, with 34.6% of the increase due to a decrease in capitalized software development costs during the first quarter of 2006, as compared to the same period in the prior year, resulting in a higher expense for this year. The balance of the increase in expense was due to growth in staffing levels, particularly in our non-core businesses.

As of September 30, 2006, our research and development resources were allocated to the following projects: 38% to MicroStrategy 8, 41% to new product initiatives, and 21% to other research and development, including our non-core businesses, Angel.com and Alarm.com.

**General and administrative expenses.** General and administrative expenses includes personnel and other costs of our executive, finance, human resources, information systems and administrative departments as well as third-party consulting, legal and other professional fees.

General and administrative expenses increased during the three months ended September 30, 2006, as compared to the same period in the prior year, with 32.1% of the increase resulting from the expense associated with a commercial dispute involving our subsidiary in Spain and 26.3% of the increase due to an increase in compensation costs and staffing levels of our general and administrative personnel. The balance of the increase was primarily due to increases in recruiting costs and in travel and entertainment expenses related to employee rewards and client entertainment.

General and administrative expenses increased during the nine months ended September 30, 2006, as compared to the same period in the prior year, with 54.2% of the increase due to an increase in compensation costs and staffing levels of our general and administrative personnel and 13.9% of the increase resulting from the expense associated with litigation relating to a commercial dispute involving our subsidiary in Spain. The balance of the increase was primarily due to increases in travel and entertainment expenses and in recruiting costs.

General and administrative expenses was affected by unfavorable foreign currency fluctuations of 1.5% during the three months ended September 30, 2006, as compared to the same period in the prior year, and by unfavorable foreign currency fluctuations of 0.6% during the three months ended September 30, 2005, as compared to the same period in the prior year. General and administrative expenses was affected by unfavorable foreign currency fluctuations of 0.2% during the nine months ended September 30, 2006, as compared to the same period in the prior year, and by unfavorable foreign currency fluctuations of 0.7% during the nine months ended September 30, 2005, as compared to the same period in the prior year.

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**Provision for Income Taxes.** Our consolidated annualized effective tax rate was 29.7% and 32.4% for the nine months ended September 30, 2006 and 2005, respectively.

The annualized effective tax rate for the nine months ended September 30, 2005 includes a tax expense related to the repatriation of foreign earnings under the special dividend repatriation provisions of the American Jobs Creation Act of 2004.

We intend to indefinitely reinvest the undistributed 2006 earnings of certain foreign subsidiaries. Accordingly, the annualized effective tax rate applied to our pre-tax income for the nine months ended September 30, 2006 did not include any provision for U.S. federal and state taxes on the projected amount of these undistributed 2006 foreign earnings. We accrue applicable U.S. federal and state taxes (net of foreign tax credits) on projected undistributed foreign subsidiary earnings that we intend to repatriate.

**Deferred Revenue and Advance Payments.** Deferred revenue and advance payments represents product support and other services fees that are collected in advance and recognized over the contract service period and product licenses revenues relating to multiple element software arrangements that include future deliverables.

The following table summarizes deferred revenue and advance payments (in thousands), as of:

|  | September 30, | December 31, |
|--|---------------|--------------|
|  | 2006          | 2005         |
| Current:                                 |               |              |
| Deferred product licenses revenue        | \$ 2,367      | \$ 2,990     |
| Deferred product support revenue         | 75,482        | 72,645       |
| Deferred other services revenue          | 13,484        | 11,780       |
|  | 91,333        | 87,415       |
| Less: billed and unpaid deferred revenue | (34,194)      | (41,541)     |
|  | \$ 57,139     | \$ 45,874    |
| Non-current:                             |               |              |
| Deferred product licenses revenue        | \$ 196        | \$ 174       |
| Deferred product support revenue         | 1,751         | 2,228        |
| Deferred other services revenue          | 17            | 18           |
|  | 1,964         | 2,420        |
| Less: billed and unpaid deferred revenue | (607)         | (866)        |
|  | \$ 1,357      | \$ 1,554     |

We offset our accounts receivable and deferred revenue for any billed and unpaid items included in deferred revenue and advance payments.

Current and non-current deferred revenue and advance payments, net of billed and unpaid deferred revenue, were \$58.5 million as of September 30, 2006, compared to \$47.4 million as of December 31, 2005. The increase was attributable to a high number of product support and other services transactions that were billed and unpaid and, therefore, offset against deferred revenue during the fourth quarter of 2005, compared to the third quarter of 2006.

Including billed and unpaid deferred revenue, we expect to recognize \$91.3 million of deferred revenue and advance payments over the next 12 months. However, the timing and ultimate recognition of our deferred revenue and advance payments depend on our performance of various service obligations, and the amount of deferred revenue and advance payments at any date should not be considered indicative of revenues for any succeeding period.



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During the three months and nine months ended September 30, 2006, we entered into certain agreements that include future commitments by our customers to purchase products, product support or other services over multi-year periods. Revenue relating to such future commitments by our customers is not included in our deferred revenue balances.

We do not expect that revenue from multi-year arrangements will constitute a substantial percentage of our total revenue in future periods. Revenue relating to such agreements will be recognized during the period in which all revenue recognition criteria are met. The timing and ultimate recognition of any revenue from such customer purchase commitments depend on our customers meeting their future purchase commitments and our meeting our associated performance obligations related to those purchase commitments.

**Liquidity and Capital Resources**

Our principal sources of liquidity are cash, cash equivalents, investments, and on-going collection of our accounts receivable. Management believes that existing capital resources and cash anticipated to be generated by operations will be sufficient to meet working capital requirements and anticipated capital expenditures for at least the next twelve months. Based upon our cash position, we do not currently expect to borrow money to finance our operations, although we may borrow money for other endeavors, including the repurchase of our own class A common stock. Our liquidity and capital resources and ability to generate revenues are subject to various business and economic risks discussed under Item 1A. Risk Factors.

On March 15, 2005, we entered into a security agreement with a bank under which we posted cash to secure existing letters of credit. These letters of credit are used as security deposits for office leases, including the office lease for our corporate headquarters. We may invest the cash collateral under the security agreement in certain permitted investments. As of each of September 30, 2006 and December 31, 2005, we had \$2.8 million and \$4.2 million, respectively, in cash collateral posted under the security agreement, all invested in money market funds that are included in restricted cash and investments in the accompanying balance sheets.

On July 28, 2005, we announced that our Board of Directors had authorized the repurchase of up to an aggregate of \$300.0 million of our class A common stock from time to time on the open market pursuant to the 2005 Share Repurchase Program. The timing and amount of any shares repurchased will be determined by our management based on its evaluation of market conditions and other factors. The 2005 Share Repurchase Program has a five-year term, but may be suspended or discontinued by us at any time. The 2005 Share Repurchase Program may be funded using our working capital, as well as proceeds from any credit facilities and other borrowing arrangements which we may enter into in the future. During the three months ended September 30, 2006, we repurchased an aggregate of 215,440 shares of our class A common stock at an average price per share of \$88.89 and an aggregate cost of \$19.2 million pursuant to the 2005 Share Repurchase Program. During the nine months ended September 30, 2006, we repurchased an aggregate of 1,379,266 shares of our class A common stock at an average price of \$95.67 and an aggregate cost of \$132.0 million pursuant to the 2005 Share Repurchase Program.

All of the amounts above relating to average price per share and aggregate cost include broker commissions.

We lease office space and computer and other equipment under operating lease agreements. In addition to base rent, we are responsible for certain taxes, utilities and maintenance costs, and several leases include options for renewal or purchase. Future minimum payments under noncancellable operating leases and agreements with initial terms of greater than one year consist of the following, net of total future minimum rentals to be received under noncancellable sublease agreements (in thousands):

| Twelve Months Ended September 30, | Amount    |
|-----------------------------------|-----------|
| 2007                              | \$ 10,630 |
| 2008                              | 10,078    |
| 2009                              | 8,754     |
| 2010                              | 6,047     |
| 2011                              | 833       |
| Thereafter                        | 1,223     |
|                                   | \$ 37,565 |

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***Net Cash Provided by Operating Activities.*** The increase in net cash provided by operating activities during the nine months ended September 30, 2006, as compared to the same period in the prior year, was primarily attributable to an improvement in deferred revenue balances, an improvement in operating results, and our utilization of deferred tax assets. These gains were partially offset by an increase in accounts receivable as a result of the increased volume of large invoices billed at the end of September 2006 and by the recognition in net cash provided by operating activities, for the first time, of the excess tax benefits from share-based payment arrangements in the amount of \$2.2 million during the nine months ended September 30, 2006 as a result of the adoption of SFAS No. 123R effective January 1, 2006.

***Net Cash Provided by Investing Activities.*** The increase in net cash provided by investing activities during the nine months ended September 30, 2006, as compared to the same period in the prior year, was primarily attributable to a decline in purchases of short and long term investments.

***Net Cash Used in Financing Activities.*** The increase in net cash used in financing activities during the nine months ended September 30, 2006, as compared to the same period in the prior year, was primarily attributable to an increase in the amount of class A common stock repurchased and the decrease in the proceeds from the sale of class A common stock under the employee stock purchase plan and the exercise of employee stock options. These proceeds decreased primarily due to the termination of the employee stock purchase plan effective July 29, 2005 and the decline in the number of employee stock options exercised from 240,000 shares during the nine months ended September 30, 2005 to 129,000 shares during the nine months ended September 30, 2006.

***Off-Balance Sheet Arrangements.*** We do not have any off-balance sheet arrangements that have or are reasonably likely to have a current or future material effect on our financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources.

## **Recent Accounting Standards**

In September 2006, the Securities and Exchange Commission ( SEC ) issued Staff Accounting Bulletin 108 Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements ( SAB 108 ). SAB 108 provides interpretive guidance on how the effects of the carryover or reversal of prior year misstatements should be considered in quantifying a current year misstatement. The SEC staff believes that registrants should quantify errors using both a balance sheet and an income statement approach and evaluate whether either approach results in quantifying a misstatement that, when all relevant quantitative and qualitative factors are considered, is material. The guidance in SAB 108 must be applied to annual financial statements for fiscal years ending after November 15, 2006. We are currently assessing the impact of adopting SAB 108 and we do not expect that it will have a material effect on our consolidated results of operations or financial position.

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In June 2006, the Financial Accounting Standards Board ( FASB ) issued FASB Interpretation No. 48 ( FIN 48 ), Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109 . FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise s financial statements in accordance with Statement of Financial Accounting Standards ( SFAS ) No. 109, Accounting for Income Taxes . It prescribes that a company should use a more-likely-than-not recognition threshold based on the technical merits of the income tax position taken. Income tax positions that meet the more-likely-than-not recognition threshold should be measured in order to determine the tax benefit to be recognized in the financial statements. FIN 48 is effective in fiscal years beginning after December 15, 2006. We are currently evaluating the impact of FIN 48 on our consolidated results of operations and financial condition.

**ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

The following discussion about our market risk exposures involves forward-looking statements. Actual results could differ materially from those projected in the forward-looking statements.

We are exposed to the impact of both interest rate changes and foreign currency fluctuations.

**Interest Rate Risk.** Our exposure to risk for changes in interest rates relates primarily to our investments. We generally invest our excess cash in short-term, highly-rated, fixed rate financial instruments. These fixed rate investments are subject to interest rate risk and may fall in value if interest rates increase.

As of September 30, 2006, we did not have any material investments.

**Foreign Currency Risk.** We conduct a significant portion of our business in currencies other than the U.S. dollar, the currency in which we report our consolidated financial statements. International sales accounted for 36.7% and 36.8% of our total revenues for the three months ended September 30, 2006 and 2005, respectively, and 36.7% and 37.7% of our total revenues for the nine months ended September 30, 2006 and 2005, respectively. We anticipate that international revenues will continue to account for a significant portion of our total revenues. The functional currency of each of our foreign subsidiaries is the local currency.

Assets and liabilities of our foreign subsidiaries are translated into U.S. dollars at exchange rates in effect as of the applicable balance sheet date and any resulting translation adjustments are included as an adjustment to stockholders equity. Revenues and expenses generated from these subsidiaries are translated at average monthly exchange rates during the quarter in which the transactions occur. Gains and losses from transactions in local currencies are included in net income.

Historically, we have generated a significant portion of our revenues and incurred a significant portion of our expenses in euro and the British pound sterling. As a result of transacting in multiple currencies and reporting our financial statements in U.S. dollars, our operating results may be adversely impacted by currency exchange rate fluctuations in the future. Further information on the impact of foreign currency exchange rate fluctuations on current and comparable periods is further described in Item 2, Management s Discussion and Analysis of Financial Condition and Results of Operations.

We cannot predict the effect of exchange rate fluctuations upon our future results. We attempt to minimize our foreign currency risk by converting our excess foreign currency held in foreign jurisdictions to U.S. dollar denominated cash and investment accounts. To date, we have not hedged the risks associated with foreign exchange exposure. Although we may do so in the future, we cannot be sure that any hedging techniques will be successful or that our business, results of operations, financial condition and cash flows will not be materially adversely affected by exchange rate fluctuations.

As of September 30, 2006, a 10% adverse change in foreign exchange rates versus the U.S. dollar would have decreased our aggregate reported cash and cash equivalents, restricted cash and investments, and short-term investments by 1.3%.

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**ITEM 4. CONTROLS AND PROCEDURES**

***Evaluation of disclosure controls and procedures.*** Our management, with the participation of our chief executive officer and chief financial officer, evaluated the effectiveness of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act) as of September 30, 2006. Management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving their objectives and management necessarily applies its judgment in evaluating the cost-benefit relationship of possible controls and procedures. Based on the evaluation of our disclosure controls and procedures as of September 30, 2006, our chief executive officer and chief financial officer concluded that, as of such date, our disclosure controls and procedures were effective at the reasonable assurance level.

***Changes in internal controls.*** No change 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 fiscal quarter ended September 30, 2006 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.



**Table of Contents****PART II. OTHER INFORMATION****ITEM 1. LEGAL PROCEEDINGS****Business Objects Litigation**

On October 17, 2001, Business Objects filed suit against us in the United States District Court for the Northern District of California, claiming that our software infringes a patent issued to Business Objects relating to relational database access (the 403 patent). The District Court granted our motion for summary judgment and dismissed the lawsuit, ruling as a matter of law that our products do not infringe the 403 patent. On appeal, the United States Court of Appeals for the Federal Circuit ruled that the District Court had correctly construed the patent, that we do not literally infringe any of the asserted patent claims, and that Business Objects is legally barred from claiming that our products infringe two of the three asserted claims under the doctrine of equivalents. On remand, the District Court granted our motion for summary judgment of non-infringement for the one remaining patent claim and dismissed the lawsuit. On September 13, 2006, the Federal Circuit affirmed the District Court's ruling.

On October 31, 2001, we filed suit against Business Objects, S.A. and its subsidiary, Business Objects Americas, Inc., in the United States District Court for the Eastern District of Virginia, claiming that Business Objects' software infringes two patents held by us relating to asynchronous control of report generation using a web browser (the 033 patent) and a system and method of adapting automatic output of OLAP reports to disparate user output devices (the 050 patent). Our amended complaint included claims for misappropriation of trade secrets and tortious interference with contractual relations. We subsequently agreed to dismissal of the 033 patent claims without prejudice and the District Court granted Business Objects' motion for summary judgment on the 050 patent claims. The District Court ruled in our favor on our claim of trade secret misappropriation and dismissed our tortious interference claim. On November 17, 2005, the Federal Circuit reversed the District Court on our tortious interference claim and remanded that claim for further proceedings, but affirmed the District Court on all other issues. On November 2, 2006, the District Court held a status conference and directed that each party may file briefing regarding how the case should proceed, including summary judgment briefing, within 30 days.

On December 10, 2003, we filed a complaint for patent infringement against Crystal Decisions, Inc. in the United States District Court for the District of Delaware. The lawsuit alleged that Crystal Decisions willfully infringed three patents issued to us relating to: (i) asynchronous control of report generation using a web browser (the 033 patent); (ii) management of an automatic OLAP report broadcast system (the 796 patent); and (iii) providing business intelligence web content with reduced client-side processing (the 432 patent). Business Objects Americas, Inc., which acquired Crystal Decisions, filed motions for summary judgment of non-infringement and invalidity of the 432, 796, and 033 patents on October 13, 2005. The District Court granted Business Objects' motions for summary judgment of non-infringement of the 033 patent and of invalidity of the 432 and 796 patents. On February 23, 2006, the District Court entered judgment in favor of Business Objects and against MicroStrategy. MicroStrategy filed a notice of appeal to the Federal Circuit on March 24, 2006. MicroStrategy's opening brief on appeal was filed on August 4, 2006. Business Objects' responsive brief is due November 17, 2006. MicroStrategy's reply brief is due December 1, 2006. No date has yet been set for oral argument at the Federal Circuit. The outcome of the litigation is uncertain.

The outcome of the legal proceedings described above is uncertain.

**Other Proceedings**

In October 2006, a commercial court in Spain rendered a judgment against us for approximately \$1.1 million, plus interest and certain costs of the proceeding, in connection with a commercial dispute involving our subsidiary in Spain. We intend to appeal the ruling. Until final adjudication of the matter on appeal, we do not expect to make any cash payment specified in the decision or post a bond or other security. As a result of the court's decision, we recorded a liability of approximately \$1.1 million as of September 30, 2006.

We are also involved in other legal proceedings through the normal course of business. Management believes that any unfavorable outcome related to these other proceedings will not have a material effect on our financial position, results of operations or cash flows.

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

You should carefully consider the risks described below before making an investment decision. The risks and uncertainties described below are not the only ones facing MicroStrategy. Additional risks and uncertainties not presently known to us or that we currently deem immaterial may also impair our business operations.

If any of the following risks actually occur, our business, financial condition or results of operations could be materially adversely affected. In such case, the trading price of our class A common stock could decline and you may lose all or part of your investment.

#### **Our quarterly operating results, revenues and expenses may fluctuate significantly, which could have an adverse effect on the market price of our stock**

For a number of reasons, including those described below, our operating results, revenues and expenses have in the past varied and may in the future vary significantly from quarter to quarter. These fluctuations could have an adverse effect on the market price of our class A common stock.

*Fluctuations in Quarterly Operating Results.* Our quarterly operating results may fluctuate, in part, as a result of:

the size, timing, volume and execution of significant orders and shipments;

the mix of products and services of customer orders, which can affect whether we recognize revenue upon the signing and delivery of our software products or whether revenue must be recognized as work progresses or over the entire contract period;

the timing of new product announcements by us or our competitors;

changes in our pricing policies or those of our competitors;

market acceptance of business intelligence software generally and of new and enhanced versions of our products in particular;

the length of our sales cycles;

changes in our operating expenses;

personnel changes;

our use of direct and indirect distribution channels;

utilization of our consulting and education services, which can be affected by delays or deferrals of customer implementation of our software products;

changes in foreign currency exchange rates;

our profitability and expectations for future profitability and its effect on our deferred tax assets and net income for the period in which any adjustment to our net deferred tax asset valuation allowance may be made;

seasonal factors, such as our traditionally lower pace of new sales in the summer; and

changes in customer budgets.

*Limited Ability to Adjust Expenses.* We base our operating expense budgets on expected revenue trends. Many of our expenses, such as office leases and certain personnel costs, are relatively fixed. We may be unable to adjust spending quickly enough to offset any unexpected revenue shortfall. Accordingly, any shortfall in revenue may cause significant variation in operating results in any quarter.

Based on the above factors, we believe that quarter-to-quarter comparisons of our operating results are not a good indication of our future performance. It is possible that in one or more future quarters, our operating results may be below the expectations of public market analysts and investors. In that event, the trading price of our class A common stock may fall.

**The trading price for our class A common stock has been and may continue to be volatile**

The trading price of our class A common stock historically has been volatile and may continue to be volatile. The trading price of our class A common stock may fluctuate widely in response to various factors, some of which are beyond our control. These factors include:

quarterly variations in our results of operations or those of our competitors;

announcements by us or our competitors of acquisitions, new products, significant contracts, commercial relationships or capital commitments;

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the emergence of new sales channels in which we are unable to compete effectively;

our ability to develop and market new and enhanced products on a timely basis;

commencement of, or our involvement in, litigation;

any major change in our board or management;

changes in governmental regulations or in the status of our regulatory approvals;

recommendations by securities analysts or changes in earnings estimates;

announcements about our earnings that are not in line with analyst expectations, the likelihood of which may be enhanced because it is our policy not to give guidance relating to our anticipated financial performance in future periods;

announcements by our competitors of their earnings that are not in line with analyst expectations;

the volume of shares of class A common stock available for public sale;

sales of stock by us or by our stockholders;

short sales, hedging and other derivative transactions involving shares of our class A common stock; and

general economic conditions and slow or negative growth of related markets.

In addition, the stock market in general, and the market for technology companies in particular, have experienced extreme price and volume fluctuations that have often been unrelated or disproportionate to the operating performance of those companies. These broad market and industry factors may seriously harm the market price of our class A common stock, regardless of our actual operating performance.

**We face the risk of a decrease in our cash balances and losses in our investment portfolio**

Our cash balances are held in numerous locations throughout the world. A portion of our cash is invested in marketable securities as part of our investment portfolio. Among other factors, changes in interest rates, foreign currency fluctuations and macroeconomic conditions could cause fluctuations in our cash balances and losses in our investment portfolio. Most amounts held outside the United States could be repatriated to the United States, but, under current law, would be subject to U.S. federal and state income tax, less applicable foreign tax credits.

**Revenue recognition accounting pronouncements may adversely affect our reported results of operations**

We continuously review our compliance with all new and existing revenue recognition accounting pronouncements. Depending upon the outcome of these ongoing reviews and the potential issuance of further accounting pronouncements, implementation guidelines and interpretations, we may be required to modify our reported results, revenue recognition policies or business practices, which could have a material adverse effect on our results of operations. Our existing revenue recognition policies are described in *Critical Accounting Policies* included in Item 7 and *Summary of Significant Accounting Policies* (Note 2) included in Item 15 of our Annual Report on Form 10-K for the

year ended December 31, 2005.

**We may have exposure to greater than anticipated tax liabilities**

We are subject to income taxes and non-income taxes in a variety of jurisdictions and our tax structure is subject to review by both domestic and foreign taxation authorities. Moreover, in the ordinary course of a multinational business, there are many intercompany transactions and calculations where the ultimate tax determination is uncertain.

In determining our provision for income taxes, net deferred tax assets, liabilities and valuation allowances, management is required to make judgments and estimates related to projections of domestic and foreign profitability, the timing and extent of the utilization of both net operating loss carryforwards and capital loss carryforwards, applicable tax rates, transfer pricing methodologies and prudent and feasible tax planning strategies. As a multinational company, the Company is required to calculate and provide for estimated income tax liabilities for each of the tax jurisdictions in which it operates. This process involves estimating current tax obligations and exposures in each jurisdiction as well as making judgments regarding the future recoverability of deferred tax assets. Changes in the estimated level of annual pre-tax income, changes in tax laws particularly related to the utilization of net operating losses in various jurisdictions, and changes resulting from tax audits can all affect the overall effective income tax rate which, in turn, impacts the overall level of income tax expense and net income.

Judgments and estimates related to the Company's projections and assumptions are inherently uncertain; therefore, actual results could differ materially from projections. The timing and manner in which the Company will utilize the net operating loss carryforwards, research and development tax credit carryforward tax assets, alternative minimum tax credit carryforward tax assets, and foreign tax credit

## **Table of Contents**

carryforward tax assets in any year, or in total, may be limited by provisions of the Internal Revenue Code regarding changes in the Company's ownership. Currently, the Company expects to use the tax assets subject to Internal Revenue Code limitations within the carryforward period.

As a result of these factors, the ultimate amount of tax obligations owed may differ from the amounts recorded in our financial statements and any such difference may materially affect our financial results in future periods.

### **If the market for business intelligence software fails to grow as we expect, or if businesses fail to adopt our products, our business, operating results and financial condition could be materially adversely affected**

Nearly all of our revenues to date have come from sales of business intelligence software and related technical support, consulting and education services. We expect these sales to account for a large portion of our revenues for the foreseeable future. Although demand for business intelligence software has grown in recent years, the market for business intelligence software applications is still emerging. Resistance from consumer and privacy groups to increased commercial collection and use of data on spending patterns and other personal behavior and European and other governmental restrictions on the collection and use of personal data may impair the further growth of this market, as may other developments. We cannot be sure that this market will continue to grow or, even if it does grow, that businesses will adopt our solutions. We have spent, and intend to keep spending, considerable resources to educate potential customers about business intelligence software in general and our solutions in particular. However, we cannot be sure that these expenditures will help our products achieve any additional market acceptance. If the market fails to grow or grows more slowly than we currently expect, our business, operating results and financial condition would be materially adversely affected.

### **Business disruptions could affect our operating results**

A significant portion of our research and development activities and certain other critical business operations are concentrated in a single geographic area. We are also a highly automated business and a disruption or failure of our systems could cause delays in completing sales and providing services. A major earthquake, fire, act of terrorism or other catastrophic event that results in the destruction or disruption of any of our critical business operations or information technology systems could severely affect our ability to conduct normal business operations and as a result our future operating results could be materially and adversely affected.

### **We use strategic channel partners and if we are unable to maintain successful relationships with them, our business, operating results and financial condition could be materially adversely affected**

In addition to our direct sales force, we use strategic channel partners such as value-added resellers, system integrators and original equipment manufacturers to license and support our products. For the nine months ended September 30, 2006 and the year ended December 31, 2005, transactions by channel partners for which we recognized revenues accounted for 10.8% and 16.8%, respectively, of our total product licenses revenues. Our channel partners generally offer customers the products of several different companies, including products that compete with ours. Because our channel partners generally do not have an exclusive relationship with us, we cannot be certain that they will prioritize or provide adequate resources to selling our products. Moreover, divergence in strategy or contract defaults by any of these channel partners may materially adversely affect our ability to develop, market, sell or support our products.

Although we believe that direct sales will continue to account for a majority of product licenses revenues, we seek to maintain a significant level of indirect sales activities through our strategic channel partners. There can be no assurance that our strategic partners will continue to cooperate with us when our distribution agreements expire or are up for renewal. In addition, there can be no assurance that actions taken or omitted to be taken by such parties will not adversely affect us. Our ability to achieve revenue growth in the future will depend in part on our success in maintaining successful relationships with our strategic partners. If we are unable to maintain our relationships with these strategic partners, our business, operating results and financial condition could be materially adversely affected.

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### **Our recognition of deferred revenue and advance payments is subject to future performance obligations and may not be representative of revenues for succeeding periods**

Our current and long-term deferred revenue and advance payments totaled \$58.5 million as of September 30, 2006. The timing and ultimate recognition of our deferred revenue and advance payments depend on various factors, including our performance of various service obligations. Because of the possibility of customer changes in development schedules, delays in implementation and development efforts and the need to satisfactorily perform product support services, deferred revenue and advance payments at any particular date may not be representative of actual revenue for any succeeding period.

### **We may not be able to sustain or increase profitability in the future**

We generated net income for each of the nine months ended September 30, 2006, and the year ended December 31, 2005; however, we may not be able to sustain or increase profitability on a quarterly or annual basis in the future. As of September 30, 2006, our accumulated deficit was \$63.7 million. If operating expenses exceed our expectations or cannot be adjusted accordingly or revenues fall below our expectations, we may cease to be profitable and our business, results of operations and financial condition may be materially and adversely affected. We have significant deferred tax assets, and if we are unable to sustain profitability, we may be required to establish a valuation allowance against these deferred tax assets, which would result in a charge that would adversely affect net income in the period in which the charge is incurred.

### **Managing our international operations is complex and our failure to do so successfully or in a cost-effective manner could have a material adverse effect on our business, operating results and financial condition**

We receive a significant portion of our total revenues from international sales from foreign direct and indirect operations. International sales accounted for 36.7% and 36.8% of our total revenues for the three months ended September 30, 2006 and 2005, respectively, and 36.7% and 37.7% of our total revenues for the nine months ended September 30, 2006 and 2005, respectively. Our international operations require significant management attention and financial resources.

There are certain risks inherent in our international business activities including:

changes in foreign currency exchange rates;

unexpected changes in regulatory requirements;

tariffs, export restrictions and other trade barriers;

costs of localizing products;

lack of acceptance of localized products;

longer accounts receivable payment cycles;

difficulties in and costs of staffing, managing and operating our international operations;

tax issues, including restrictions on repatriating earnings;

weaker intellectual property protection;

economic weakness or currency related crises;

the burden of complying with a wide variety of laws (including labor laws);

generally longer payment cycles and greater difficulty in collecting accounts receivable;



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our ability to adapt to sales practices and customer requirements in different cultures; and

political instability in the countries where we are doing business.

These factors may have a material adverse effect on our future international sales and, consequently, on our business, operating results and financial condition.

### **We may lose sales, or sales may be delayed, due to the long sales and implementation cycles for our products, which could reduce our revenues**

To date, our customers have typically invested substantial time, money and other resources and involved many people in the decision to license our software products and purchase our consulting and other services. As a result, we may wait nine months or more after the first contact with a customer for that customer to place an order while it seeks internal approval for the purchase of our products and/or services. During this long sales cycle, events may occur that affect the size and/or timing of the order or even cause it to be canceled. For example, our competitors may introduce new products, or the customer's own budget and purchasing priorities may change.

Even after an order is placed, the time it takes to deploy our products and complete consulting engagements can vary widely. Implementing our product can take several months, depending on the customer's needs, and may begin only with a pilot program. It may be difficult to deploy our products if the customer has complicated deployment requirements, which typically involve integrating databases, hardware and software from different vendors. If a customer hires a third party to deploy our products, we cannot be sure that our products will be deployed successfully.

### **Our customers include the U.S. government and a number of other state and local governments or agencies**

Our customers include the U.S. government and a number of other state and local governments and agencies. There are a variety of risks in doing business with government entities, including:

*Procurement.* Contracting with public sector customers is highly competitive and can be time-consuming and expensive, requiring that we incur significant upfront time and expense without any assurance that we will win a contract.

*Budgetary Constraints and Cycles.* Demand and payment for our products and services are impacted by public sector budgetary cycles and funding availability, with funding reductions or delays adversely impacting public sector demand for our products and services.

*Modification or Cancellation of Contracts.* Public sector customers often have contractual or other legal rights to terminate current contracts for convenience or due to a default. If a contract is cancelled for convenience, which can occur if the customer's product needs change, we may only be able to collect for products and services delivered prior to termination. If a contract is cancelled because of default, we may only be able to collect for products and services delivered, and we may be forced to pay any costs incurred by the customer for procuring alternative products and services.

*Governmental Audits.* U.S. government and other state and local agencies routinely investigate and audit government contractors for compliance with a variety of complex laws and regulations relating to the formation, administration or performance of government contracts, which may include, but are not limited to, provisions governing reports of and remittances of fees based on sales under government contracts, price protection, compliance with socio-economic policies, and other terms that are particular to government contracts. If, as a result of these or other audits or reviews, it is determined that we have failed to comply with such laws, regulations or contracts, we may be subject to civil and criminal penalties and administrative sanctions, including termination of contracts, forfeiture of fees, fines and suspensions or debarment from future government business.

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### **We face intense competition, which may lead to lower prices for our products, reduced gross margins, loss of market share and reduced revenue**

The markets for business intelligence software, analytical applications and information delivery are intensely competitive and subject to rapidly changing technology. In addition, many companies in these markets are offering, or may soon offer, products and services that may compete with MicroStrategy products.

MicroStrategy faces competitors in several broad categories, including business intelligence software, analytical processes, query and web-based reporting tools, and report delivery. Our competitors that are primarily focused on business intelligence products include, among others, Actuate, Business Objects, Cognos, Hyperion Solutions, Information Builders and the SAS Institute. We also compete with large software corporations, including suppliers of enterprise resource planning software that provide one or more capabilities competitive with our products, including IBM, Microsoft, Oracle, SAP AG and others.

Many of our competitors have longer operating histories, significantly greater financial, technical, marketing or other resources, and greater name recognition than we do. In addition, many of our competitors have strong relationships with current and potential customers and extensive knowledge of the business intelligence industry. As a result, they may be able to respond more quickly to new or emerging technologies and changes in customer requirements or devote greater resources to the development, promotion and sale of their products than we can. Increased competition may lead to price cuts, reduced gross margins and loss of market share. We may not be able to compete successfully against current and future competitors and the failure to meet the competitive pressures we face may have a material adverse effect on our business, operating results and financial condition.

Current and future competitors may also make strategic acquisitions or establish cooperative relationships among themselves or with others. By doing so, they may increase their ability to meet the needs of our potential customers. Our current or prospective indirect channel partners may establish cooperative relationships with our current or future competitors. These relationships may limit our ability to sell our products through specific distribution channels. Accordingly, new competitors or alliances among current and future competitors may emerge and rapidly gain significant market share. These developments could limit our ability to obtain revenues from new customers and to maintain technical support revenues from our installed customer base.

### **We depend on technology licensed to us by third parties, and the loss of this technology could impair our software, delay implementation of our products, or force us to pay higher license fees**

We license third-party technologies that we incorporate into our existing products. There can be no assurance that the licenses for such third-party technologies will not be terminated or that we will be able to license third-party software for future products. In addition, we may be unable to renegotiate acceptable third-party license terms. Changes in or the loss of third party licenses could lead to a material increase in the costs of licensing or to our software products becoming inoperable or their performance being materially reduced, with the result that we may need to incur additional development costs to ensure continued performance of our products, and we may experience a decreased demand for our products.

### **We depend on revenue from a single suite of products**

Our MicroStrategy 8 suite of products accounts for a substantial portion of our revenue. Because of this revenue concentration, our business could be harmed by a decline in demand for, or in the prices of, our MicroStrategy 8 software as a result of, among other factors, any change in our pricing model, increased competition, a maturation in the markets for these products or other risks described in this document.

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### **If we are unable to recruit or retain skilled personnel, or if we lose the services of any of our key management personnel, our business, operating results and financial condition could be materially adversely affected**

Our future success depends on our continuing ability to attract, train, assimilate and retain highly skilled personnel. Competition for these employees is intense. We may not be able to retain our current key employees or attract, train, assimilate or retain other highly skilled personnel in the future. Our future success also depends in large part on the continued service of key management personnel, particularly Michael J. Saylor, our Chairman, President and Chief Executive Officer, and Sanju K. Bansal, our Vice Chairman, Executive Vice President and Chief Operating Officer. If we lose the services of one or both of these individuals or other key personnel, or if we are unable to attract, train, assimilate and retain the highly skilled personnel we need, our business, operating results and financial condition could be materially adversely affected.

### **If we are unable to develop and release product enhancements and new products to respond to rapid technological change in a timely and cost-effective manner, our business, operating results and financial condition could be materially adversely affected**

The market for our products is characterized by rapid technological change, frequent new product introductions and enhancements, changing customer demands and evolving industry standards. The introduction of products embodying new technologies can quickly make existing products obsolete and unmarketable. We believe that our future success depends largely on three factors:

our ability to continue to support a number of popular operating systems and databases;

our ability to maintain and improve our current product line; and

our ability to rapidly develop new products that achieve market acceptance, maintain technological competitiveness and meet an expanding range of customer requirements.

Business intelligence applications are inherently complex, and it can take a long time and require significant research and development expenditures to develop and test new products and product enhancements. In addition, customers may delay their purchasing decisions because they anticipate that new or enhanced versions of our products will soon become available. We cannot be sure that we will succeed in developing and marketing, on a timely and cost-effective basis, product enhancements or new products that respond to technological change or new customer requirements, nor can we be sure that any new products and product enhancements will achieve market acceptance. Moreover, even if we introduce such a product, we may experience a decline in revenues of our existing products that is not fully matched by the new product's revenue. In addition, we may lose existing customers who choose a competitor's product rather than migrate to our new product. This could result in a temporary or permanent revenue shortfall and materially affect our business.

### **The emergence of new industry standards may adversely affect the demand for our existing products**

The emergence of new industry standards in related fields may adversely affect the demand for our existing products. This could happen, for example, if new web standards and technologies emerged that were incompatible with customer deployments of our products. MicroStrategy currently supports SQL and MDX standards in database access technology. If we are unable to adapt our products on a timely basis to new standards in database access technology, the ability of MicroStrategy's products to access customer databases could be impaired. In addition, the emergence of new standards in the field of operating system support could adversely affect the demand for our existing products. MicroStrategy technology is currently compatible with nearly all major operating systems, including, among others, Windows Server, Sun Solaris, IBM AIX, HP's HP-UX and Red Hat Linux AS. If a different operating system were to gain widespread acceptance, we may not be able to achieve compatibility on a timely basis, resulting in an adverse effect on the demand for our products.

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### **The nature of our products makes them particularly vulnerable to undetected errors, or bugs, which could cause problems with how the products perform and which could in turn reduce demand for our products, reduce our revenue and lead to product liability claims against us**

Software products as complex as ours may contain errors and/or defects. Although we test our products extensively, we have in the past discovered software errors in our products after their introduction. Despite testing by us and by our current and potential customers, errors may be found in new products or releases after commercial shipments begin. This could result in lost revenue, damage to our reputation or delays in market acceptance, which could have a material adverse effect upon our business, operating results and financial condition. We may also have to expend resources and capital to correct these defects.

Our license agreements with customers typically contain provisions designed to limit our exposure to product liability, warranty and other claims. It is possible, however, that these provisions may not be effective under the laws of certain domestic or international jurisdictions and we may be exposed to product liability, warranty and other claims. A successful product liability claim against us could have a material adverse effect on our business, operating results and financial condition.

### **Our intellectual property rights are valuable, and any inability to protect them could reduce the value of our products, services and brand**

We rely on a combination of copyright, patent, trade secrets, confidentiality procedures and contractual commitments to protect our proprietary information. Despite our efforts, these measures can only provide limited protection. Unauthorized third parties may try to copy or reverse engineer portions of our products or otherwise obtain and use our intellectual property. Any patents owned by us may be invalidated, circumvented or challenged. Any of our pending or future patent applications, whether or not being currently challenged, may not be issued with the scope of the claims we seek, if at all. In addition, the laws of some countries do not provide the same level of protection of our proprietary rights as do the laws of the United States. If we cannot protect our proprietary technology against unauthorized copying or use, we may not remain competitive.

### **Third parties may claim we infringe their intellectual property rights**

We periodically receive notices from others claiming we are infringing their intellectual property rights, principally patent rights. We expect the number of such claims will increase as the number of products and competitors in our industry segments grows, the functionality of products overlap, and the volume of issued software patents and patent applications continues to increase. Responding to any infringement claim, regardless of its validity, could:

be time-consuming, costly and/or result in litigation;

divert management's time and attention from developing our business;

require us to pay monetary damages or enter into royalty and licensing agreements that we would not normally find acceptable;

require us to stop selling or to redesign certain of our products; or

require us to satisfy indemnification obligations to our customers.

If a successful claim is made against us and we fail to develop or license a substitute technology, our business, results of operations, financial condition or cash flows could be adversely affected.

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### **Pending or future litigation could have a material adverse impact on our results of operation and financial condition**

In addition to intellectual property litigation, from time to time, we have been subject to other litigation. Where we can make a reasonable estimate of the liability relating to pending litigation and determine that it is probable, we record a related liability. As additional information becomes available, we assess the potential liability and revise estimates as appropriate. However, because of uncertainties relating to litigation, the amount of our estimates could be wrong. In addition to the related cost and use of cash, pending or future litigation could cause the diversion of management's attention and resources.

### **Because of the rights of our two classes of common stock, and because we are controlled by our existing holders of class B common stock, these stockholders could transfer control of MicroStrategy to a third party without the approval of our Board of Directors or our other stockholders, prevent a third party from acquiring MicroStrategy, or limit your ability to influence corporate matters**

We have two classes of common stock: class A common stock and class B common stock. Holders of our class A common stock generally have the same rights as holders of our class B common stock, except that holders of class A common stock have one vote per share while holders of class B common stock have ten votes per share. As of November 1, 2006, holders of our class B common stock owned 3,101,209 shares of class B common stock, or 76.5% of the total voting power. Michael J. Saylor, our Chairman, President and Chief Executive Officer, beneficially owned 235,800 shares of class A common stock and 2,730,547 shares of class B common stock, or 67.9% of the total voting power, as of November 1, 2006. Accordingly, Mr. Saylor is able to control MicroStrategy through his ability to determine the outcome of elections of our directors, amend our certificate of incorporation and by-laws and take other actions requiring the vote or consent of stockholders, including mergers, going-private transactions and other extraordinary transactions and their terms.

Our certificate of incorporation allows holders of class B common stock, almost all of whom are current employees or former employees of our company or related parties, to transfer shares of class B common stock, subject to the approval of stockholders possessing a majority of the outstanding class B common stock. Mr. Saylor or a group of stockholders possessing a majority of the outstanding class B common stock could, without the approval of our Board of Directors or our other stockholders, transfer voting control of MicroStrategy to a third party. Such a transfer of control could have a material adverse effect on our business, operating results and financial condition. Mr. Saylor or a group of stockholders possessing a majority of the outstanding class B common stock will also be able to prevent a change of control of MicroStrategy, regardless of whether holders of class A common stock might otherwise receive a premium for their shares over the then current market price. In addition, this concentrated control limits your ability to influence corporate matters and, as a result, we may take actions that our non-controlling stockholders do not view as beneficial. As a result, the market price of our class A common stock could be adversely affected.

**Table of Contents****ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS**

The following table provides information about our repurchases of equity securities during the periods indicated that are registered by us pursuant to Section 12 of the Exchange Act:

|                   |                    | (a)  | (b)   | (c)  | (d)  |
|-------------------|--------------------|--|---|--|--|
| <b>Period</b>     |                    | <b>Total Number of Shares (or Units) Purchased</b> | <b>Average Price Paid per Share (or Unit) (1)</b> | <b>Total Number of Shares (or Units) Purchased as Part of Publicly Announced Plans or Programs (2)</b> | <b>Maximum Number (or Approximate Dollar Value) of Shares (or Units) that May Yet Be Purchased Under the Plans or Programs (2)</b> |
| July 1, 2006      | July 31, 2006      | 12,000   | \$ 83.60  | 12,000   | \$ 179,264,792   |
| August 1, 2006    | August 31, 2006    | 153,900  | \$ 88.39  | 153,900  | \$ 165,661,336   |
| September 1, 2006 | September 30, 2006 | 49,540   | \$ 91.74  | 49,540   | \$ 161,116,531   |
| <b>Total:</b>     |                    | <b>215,440</b>                                     | <b>\$ 88.89</b>                                   | <b>215,440</b>   | <b>\$ 161,116,531</b>  |

(1) The Average Price Paid per Share includes broker commissions.

(2) On July 28, 2005, we announced that our Board of Directors had authorized our repurchase of up to an aggregate of \$300.0 million of our class A common stock from time to time on the open market, pursuant to the 2005 Share Repurchase Program. The timing and amount of any shares repurchased is determined by our management based on its evaluation of market conditions and other factors. The 2005 Share Repurchase Program has a five-year term, but may be suspended or discontinued by us at any time. The 2005 Share Repurchase Program may be funded using our working capital, as well as proceeds from any credit facilities and other borrowing arrangements which we may enter into in the future.

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**ITEM 6. EXHIBITS**

**Exhibit**

| <b>Number</b>   | <b>Description</b>   |
|---|--|
| 3.1   | Second Restated Certificate of Incorporation of the registrant (filed as Exhibit 3.1 to the registrant's Quarterly Report on Form 10-Q for the quarterly period ended March 31, 2003 (File No. 000-24435) and incorporated by reference herein).   |
| 3.2   | Amended and Restated By-Laws of the registrant (filed as Exhibit 3.2 to the registrant's Annual Report on Form 10-K for the fiscal year ended December 31, 2003 (File No. 000-24435) and incorporated by reference herein).  |
| 4.1   | Form of Certificate of Class A Common Stock of the registrant (filed as Exhibit 4.1 to the registrant's Quarterly Report on Form 10-Q for the quarterly period ended June 30, 2003 (File No. 000-24435) and incorporated by reference herein).   |
| 4.2   | Warrant Agreement, dated as of January 11, 2001, by and between the registrant and American Stock Transfer & Trust Company, included as Exhibit E to the Stipulation of Settlement regarding the settlement of the class action lawsuit, dated as of January 11, 2001 (filed as Exhibit 10.29 to the registrant's Annual Report on Form 10-K for the fiscal year ended December 31, 2000 (File No. 000-24435) and incorporated by reference herein). |
| 31.1  | Certification pursuant to Rule 13a-14(a) or Rule 15d-14(a) of the Chairman of the Board of Directors, President and Chief Executive Officer.   |
| 31.2  | Certification pursuant to Rule 13a-14(a) or Rule 15d-14(a) of the Vice President, Finance and Chief Financial Officer.   |
| 32  | Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.  |
| All other items included in this Quarterly Report on Form 10-Q are omitted because they are not applicable or the answers thereto are none. |  |

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**SIGNATURES**

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

**MICROSTRATEGY INCORPORATED**

By: /s/ Michael J. Saylor  
Michael J. Saylor  
Chairman of the Board of Directors,  
President and Chief Executive Officer

By: /s/ Arthur S. Locke, III  
Arthur S. Locke, III  
Vice President, Finance and Chief Financial Officer

Date: November 8, 2006



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