

Mattersight Corp
Form 10-Q
May 08, 2014
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

Form 10-Q

(Mark One)

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
FOR THE QUARTERLY PERIOD ENDED MARCH 31, 2014

OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
FOR THE TRANSITION PERIOD FROM _____ TO _____

Commission File Number 0-27975

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

Delaware
(State or Other Jurisdiction of
Incorporation or Organization)

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

200 S. Wacker Drive

Suite 820

Chicago, Illinois
(Address of Registrant's Principal Executive Offices)
(877) 235-6925

60606
(Zip Code)

(Registrant's Telephone Number, Including Area Code)

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

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

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

Large accelerated filer

Accelerated filer

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

Smaller reporting company

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

The number of shares of the registrant's Common Stock outstanding as of April 29, 2014 was 19,074,434.

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

	March 31, 2014	December 31, 2013
ASSETS:		
Current Assets:		
Cash and cash equivalents	\$ 8,101	\$ 13,392
Receivables (net of allowances of \$12 as of March 31, 2014 and \$12 as of December 31, 2013)	2,435	2,384
Prepaid expenses	4,309	3,576
Other current assets	362	427
Total current assets	15,207	19,779
Equipment and leasehold improvements, net	4,922	5,158
Goodwill	972	972
Intangibles, net	453	409
Other long-term assets	4,328	4,431
Total assets	\$ 25,882	\$ 30,749
LIABILITIES AND STOCKHOLDERS EQUITY:		
Current Liabilities:		
Accounts payable	\$ 779	\$ 752
Accrued compensation and related costs	1,424	1,844
Unearned revenue	5,390	7,215
Other current liabilities	4,694	4,098
Total current liabilities	12,287	13,909
Long-term unearned revenue	3,210	2,866
Other long-term liabilities	1,584	1,607
Total liabilities	17,081	18,382
Series B Stock, \$0.01 par value; 5,000,000 shares authorized and designated; 1,649,122 shares issued and outstanding at March 31, 2014 and December 31, 2013, with a liquidation preference of \$9,441 and \$9,294 at March 31, 2014 and December 31, 2013, respectively	8,411	8,411
Stockholders Equity:		

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Preferred Stock, \$0.01 par value; 35,000,000 shares authorized; none issued and outstanding			
Common Stock, \$0.01 par value; 50,000,000 shares authorized; 20,750,724 and 20,465,984 shares issued at March 31, 2014 and December 31, 2013, respectively; and 19,074,434 and 18,886,966 outstanding at March 31, 2014 and December 31, 2013, respectively	208		205
Additional paid-in capital	228,976		228,038
Accumulated deficit	(216,135)		(212,172)
Treasury stock, at cost, 1,676,290 and 1,579,018 shares at March 31, 2014 and December 31, 2013, respectively	(8,631)		(8,082)
Accumulated other comprehensive loss	(4,028)		(4,033)
Total stockholders equity	390		3,956
Total liabilities and stockholders equity	\$ 25,882	\$	30,749

See accompanying notes to the Condensed Consolidated Financial Statements.

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MATTERSIGHT CORPORATION
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(Unaudited and in thousands, except per share data)

	For the Three Months Ended March 31,	
	2014	2013
Revenue:		
Behavioral Analytics revenue	\$ 6,749	\$ 8,194
Other revenue	232	322
Total services revenue	6,981	8,516
Reimbursed expenses	32	82
Total revenue	7,013	8,598
Operating expenses:		
Cost of Behavioral Analytics revenue	2,098	2,723
Cost of Other revenue	103	156
Cost of services	2,201	2,879
Reimbursed expenses	32	82
Total cost of revenue, exclusive of depreciation and amortization shown below:	2,233	2,961
Sales, marketing and development	5,221	6,230
General and administrative	2,250	2,271
Depreciation and amortization	743	966
Total operating expenses	10,447	12,428
Operating loss	(3,434)	(3,830)
Interest and other expense, net	(150)	(91)
Change in fair value of warrant liability	(370)	
Loss before income taxes	(3,954)	(3,921)
Income tax (provision) benefit	(9)	248
Net loss	(3,963)	(3,673)
Dividends related to Series B Stock	(147)	(147)
Net loss available to Common Stock holders	\$ (4,110)	\$ (3,820)
Per share of Common Stock:		
Basic net loss available to Common Stock holders	\$ (0.22)	\$ (0.23)

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Diluted net loss available to Common Stock holders	\$ (0.22)	\$ (0.23)
Shares used to calculate basic net loss per share	18,503	16,320
Shares used to calculate diluted net loss per share	18,503	16,320

Stock-based compensation, primarily restricted stock, is included in individual line items above:

Cost of Behavioral Analytics revenue	\$ 56	\$ 4
Sales, marketing and development	590	849
General and administrative	442	518

See accompanying notes to the Condensed Consolidated Financial Statements.

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MATTERSIGHT CORPORATION
CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE LOSS
(Unaudited and in thousands)

	For the Three Months Ended March 31,	
	2014	2013
Net loss	\$ (3,963)	\$ (3,673)
Other comprehensive loss:		
Effect of currency translation	5	(8)
Comprehensive net loss	\$ (3,958)	\$ (3,681)

See accompanying notes to the Condensed Consolidated Financial Statements.

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MATTERSIGHT CORPORATION
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited and in thousands)

	For the Three Months Ended March 31,	
	2014	2013
Cash Flows from Operating Activities:		
Net loss	\$ (3,963)	\$ (3,673)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	743	966
Stock-based compensation	1,088	1,371
Change in fair value of warrant liability	370	
Changes in assets and liabilities:		
Receivables	(51)	(614)
Prepaid expenses	(664)	30
Other assets	66	(38)
Accounts payable	27	489
Accrued compensation and related costs	(420)	(147)
Unearned revenue	(1,481)	964
Other liabilities	62	(215)
Total Adjustments	(260)	2,806
Net cash used in operating activities	(4,223)	(867)
Cash Flows from Investing Activities:		
Capital expenditures and other	(66)	(219)
Patents and trademarks	(65)	(53)
Net cash used in investing activities	(131)	(272)
Cash Flows from Financing Activities:		
Principal payments under capital lease obligations	(422)	(629)
Acquisition of treasury stock	(549)	(195)
Proceeds from stock compensation and employee stock purchase plans, net	36	36
Fees from issuance of Common Stock	(2)	
Net cash used in financing activities	(937)	(788)
Effect of exchange rate changes on cash and cash equivalents		(12)
Decrease in cash and cash equivalents	(5,291)	(1,939)
Cash and cash equivalents, beginning of period	13,392	14,419

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Cash and cash equivalents, end of period	\$	8,101	\$	12,480
Non-Cash Investing and Financing Transactions:				
Capital lease obligations incurred	\$	420	\$	785
Capital equipment purchased on credit		420		785
Fair value of warrants classified as liability		1,155		
Supplemental Disclosures of Cash Flow Information:				
Interest paid	\$	76	\$	71

See accompanying notes to the Condensed Consolidated Financial Statements.

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MATTERSIGHT CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

Note One General

In the opinion of management, the accompanying unaudited condensed consolidated financial statements of Mattersight Corporation (we, Mattersight, or the Company) include all normal and recurring adjustments necessary for a fair presentation of our condensed consolidated financial position as of March 31, 2014 and December 31, 2013, the condensed consolidated results of our operations for the three months ended March 31, 2014 and March 31, 2013, the condensed consolidated statements of our comprehensive loss for the three months ended March 31, 2014 and March 31, 2013, and our condensed consolidated cash flows for the three months ended March 31, 2014 and March 31, 2013, and are in accordance with United States generally accepted accounting principles (GAAP) and in conformity with Securities and Exchange Commission (SEC) Article 8-03 of Regulation S-X; provided, that certain information and disclosures normally included in financial statements prepared in accordance with GAAP have been condensed or omitted.

The accompanying unaudited condensed consolidated financial statements should be read in conjunction with the audited consolidated financial statements and the notes thereto in Mattersight s Annual Report on Form 10-K for the fiscal year ended December 31, 2013 filed with the SEC on March 13, 2014. The results of operations for the three months ended March 31, 2014 are not necessarily indicative of the results to be expected for the full year.

The preparation of financial statements in conformity with GAAP requires management to make certain estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting periods. Actual results could differ from those estimates.

Note Two Summary of Significant Accounting Policies

For a description of the Company s Summary of Significant Accounting Policies, see Note Two Summary of Significant Accounting Policies of the Notes to Consolidated Financial Statements included in our Annual Report filed on Form 10-K for the year ended December 31, 2013.

Note Three Revenue Recognition

Behavioral Analytics Revenue

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

Managed services revenue consists of planning, deployment, training, and subscription fees derived from Behavioral Analytics contracts. Planning, deployment, and training fees, which are considered to be installation fees related to Behavioral Analytics subscription contracts, are deferred until the installation is complete and are then recognized over the applicable subscription period. Subscription periods generally range from three to five years after the go-live date or, in cases where the Company contracts with a client for a short-term pilot of a Behavioral Analytics offering prior to committing to a longer subscription period, if any, the subscription or pilot periods generally range from three

to twelve months after the go-live date. Installation costs incurred are deferred up to an amount not to exceed the amount of deferred installation revenue and additional amounts that are recoverable based on the contractual arrangement. These costs are included in Prepaid expenses and Other long-term assets. Such costs are amortized over the applicable subscription period. Costs in excess of the foregoing revenue amount are expensed in the period incurred.

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

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

Table of Contents**Other Revenue**

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

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

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

Note Four Stock-Based Compensation

The Company has two stock-based compensation plans, the Mattersight Corporation 1999 Stock Incentive Plan (the 1999 Plan) and the Mattersight Corporation Employee Stock Purchase Plan (the ESPP), each as described more fully in Note Thirteen in the Company's Annual Report filed on Form 10-K for the year ended December 31, 2013.

	For the Three Months Ended	
	March 31,	March 31,
	2014	2013
Stock-based compensation expense (in millions)	\$ 1.1	\$ 1.4

The Company recognizes stock-based compensation expense on a straight-line basis over the vesting period. The Company has established its forfeiture rate based on historical experience.

As of March 31, 2014, there were a total of 2,200,311 shares of the Company's common stock, par value \$0.01 per share (Common Stock), available for future grants under the 1999 Plan and from treasury stock. The Common Stock is traded on the NASDAQ Global Market under the symbol MATR.

Restricted Stock

Restricted stock award activity was as follows for the three months ended March 31, 2014:

	Shares	Weighted Average Price
Nonvested balance at December 31, 2013	450,223	\$ 6.25
Granted	303,855	\$ 5.68
Vested	(282,781)	\$ 5.84
Forfeited	(27,821)	\$ 5.98
Nonvested balance at March 31, 2014	443,476	\$ 6.13

	For the Three Months Ended	
	March 31,	March 31,
	2014	2013
(In millions)		
Total fair value of restricted and installment stock awards vested	\$ 1.6	\$ 0.5
Compensation expense related to restricted stock awards	0.5	0.6

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As of March 31, 2014, there remained \$2.0 million of unrecognized compensation expense related to restricted stock awards. These costs are expected to be recognized over a weighted average period of 1.6 years.

Stock Options

During the three months ended March 31, 2014, one employee received options to purchase a total of 70,000 shares of Common Stock. The exercise price per share is \$5.81, the closing price for shares of Common Stock on February 12, 2014, the grant date. The options will vest 25% on February 28, 2015, and the balance will vest ratably over the following 12 quarters, with a maximum exercise term of 10 years.

Option activity was as follows for the three months ended March 31, 2014:

	Options	Weighted Average Exercise Price
Outstanding as of December 31, 2013	2,014,238	\$ 7.98
Granted	70,000	\$ 5.81
Exercised		\$
Forfeited	(3,125)	\$ 7.99
Outstanding as of March 31, 2014	2,081,113	\$ 7.91
Exercisable as of March 31, 2014	1,281,423	\$ 9.42
Outstanding intrinsic value at March 31, 2014 (in millions)	\$ 2.7	
Exercisable intrinsic value at March 31, 2014 (in millions)	\$ 1.4	
	For the Three Months Ended March 31, 2014	March 31, 2013
Compensation expense related to option awards (in millions)	\$ 0.3	\$ 0.3
	For the Three Months Ended March 31, 2014	March 31, 2013
(In millions)		
Total fair value of stock options vested	\$ 0.3	\$ 0.2
Intrinsic value of stock options exercised		
Proceeds received from option exercises		

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As of March 31, 2014, there remained \$2.5 million of unrecognized compensation expense related to stock options. These costs are expected to be recognized over a weighted average period of 1.7 years.

The fair value for options granted for the three months ended March 31, 2014 and March 31, 2013 was estimated on the date of grant using a Black-Scholes option-pricing model. The following assumptions represent the year-to-date weighted average for all option grants issued:

	For the Three Months Ended	
	March 31, 2014	March 31, 2013
Risk-free interest rates	1.22%	0.62%
Expected dividend yield		
Expected volatility	64%	67%
Expected lives	6 years	6 years

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

Other Stock Compensation***Employee Stock Purchase Plan***

The ESPP is intended to qualify as an employee stock purchase plan under section 423 of the Internal Revenue Code. Under the ESPP, eligible employees are permitted to purchase shares of Common Stock at below-market prices. The purchase period opens on the first day and ends on the last business day of each calendar quarter. The shares of Common Stock issued in respect of employee purchases under the ESPP were as follows:

	For the Three Months Ended	
	March 31, 2014	March 31, 2013
Shares of Common Stock issued	8,706	9,590
Expense related to ESPP (in thousands)	\$ 10	\$ 9

The fair value for ESPP purchases for the three months ended March 31, 2014 and March 31, 2013 was estimated using a Black-Scholes pricing model. The Company used the following year-to-date weighted average assumptions:

	For the Three Months Ended	
	March 31, 2014	March 31, 2013
Risk-free interest rates	0.07%	0.07%
Expected dividend yield		
Expected volatility	40%	28%
Expected lives	0.24 years	0.24 years

Note Five Severance and Related Costs

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

For the three months ended March 31, 2014 and March 31, 2013, there was no expense and no cash payments related to cost-reduction actions and facility operating expense. There was no amount reserved for severance and related costs as of March 31, 2014.

Note Six Current Prepaid Expenses

Current prepaid expenses primarily consist of deferred costs and prepaid commissions related to Behavioral Analytics contracts. These costs are recognized over the subscription periods of the respective contracts, generally three to five

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years after the go-live date or, in cases where the Company contracts with a client for a short-term pilot of a Behavioral Analytics offering prior to committing to a longer subscription period, if any, the subscription or pilot periods generally range from three to twelve months after the go-live date. Costs included in current prepaid expenses will be recognized within the next twelve months.

Current prepaid expenses consisted of the following:

(In millions)	March 31, 2014	As of December 31, 2013
Deferred costs	\$ 1.1	\$ 1.1
Prepaid commissions	1.3	1.2
Other	1.9	1.3
Total	\$ 4.3	\$ 3.6

Table of Contents**Note Seven Intangible Assets, net**

Intangible assets reflect costs related to patent and trademark applications, Marketing Managed Services customer relationships acquired in 2004, and the 2003 purchase of a license for certain intellectual property. Patent and trademark applications are amortized over 120 months. The other intangible assets are fully amortized. Amortization expense of intangible assets for the three months ended March 31, 2014 was \$21 thousand and will be \$100 thousand annually thereafter. Amortization expense of intangible assets for the three months ended March 31, 2013 was \$40 thousand.

(In millions)	March 31, 2014	As of December 31, 2013
Gross intangible assets	\$ 3.3	\$ 3.2
Accumulated amortization of intangible assets	(2.8)	(2.8)
Total	\$ 0.5	\$ 0.4

Note Eight Other Long-Term Assets

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

(In millions)	March 31, 2014	As of December 31, 2013
Deferred costs	\$ 1.7	\$ 1.8
Prepaid commissions	1.8	1.8
Other	0.8	0.8
Total	\$ 4.3	\$ 4.4

Note Nine Short-Term Debt

On August 19, 2013, the Company together with its wholly-owned subsidiaries Mattersight Europe Holding Corporation and Mattersight International Holding, Inc., as co-borrowers, entered into a Loan and Security Agreement with Partners for Growth IV, L.P. (PfG) (the Credit Facility). In connection with the execution of the Credit Facility, the Company granted to PfG, certain affiliates of PfG, and Silicon Valley Bank warrants (collectively, the PfG Warrants) to purchase shares of Common Stock. See Note Thirteen Stock Warrants for additional information. The Credit Facility is subordinated to the Company s \$10.0 million credit facility with Silicon Valley Bank described below and, in combination therewith, brings the Company s aggregate lines of credit to \$15.0 million. The Credit Facility provides for (a) a \$3.0 million revolving line of credit maturing in 2016 (the Tranche A Facility) and (b) a \$2.0 million convertible term loan (the Tranche B Facility), which, if advanced, would be funded in two tranches of

\$1.0 million, each evidenced by a convertible promissory note (each, a Convertible Note) maturing five years following the issuance thereof. The Company has not drawn on the Credit Facility and there are no amounts outstanding as of March 31, 2014.

With respect to the Tranche A Facility, upon entering into the Credit Facility in August 2013, the Company paid a commitment fee of \$60 thousand, equal to two percent (2.0%) of the Tranche A Facility commitment, and will pay an annual commitment fee of one percent (1.0%) of the Tranche A Facility commitment in each of 2014 and 2015. With respect to the Tranche B Facility, upon entering into the Credit Facility in August 2013, the Company paid a commitment fee of \$20 thousand, equal to one percent (1.0%) of the Tranche B Facility commitment, and will pay one percent (1.0%) of the Tranche B Facility commitment upon the advance of each Convertible Note. Furthermore, the principal amount outstanding under the Credit Facility, if drawn upon, will accrue interest at a fixed annual rate equal to nine and three quarters percent (9.75%) per annum, payable monthly, which, if the Company meets certain earnings and EBITDA targets, will be reduced to eight and three quarters percent (8.75%) per annum, payable monthly.

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On May 30, 2013, the Company, together with its wholly-owned subsidiaries Mattersight Europe Holding Corporation and Mattersight International Holding, Inc., as co-borrowers, entered into an Amended and Restated Loan and Security Agreement with Silicon Valley Bank (the Amended and Restated Credit Facility). The Amended and Restated Credit Facility (i) extended the maturity date of the Company's \$10.0 million revolving line with Silicon Valley Bank to 2015, (ii) modified the borrowing base from one based upon the Company's unrestricted cash to one based upon the Company's available accounts receivable, (iii) provided for a varying interest rate based on the Company's ratio of unrestricted cash to debt, and (iv) requires the Company to maintain a tangible net worth of at least \$3.0 million. The terms and conditions of the Amended and Restated Credit Facility are otherwise substantially the same as those contained in the Loan and Security Agreement, dated June 29, 2012, by and between the Company, the subsidiary co-borrowers thereto, and Silicon Valley Bank. Through the maturity date, the Company is obligated to pay a fee equal to one-eighth of one percent (0.125%) per annum of the average unused portion of the Amended and Restated Credit Facility, payable quarterly in arrears. There was no interest expense for the three months March 31, 2014 and there was less than \$0.1 million of interest expense for the three months ended March 31, 2013. The interest rate for the three months ended March 31, 2014 was 4%. The Company was in compliance with all of its debt covenants under the Amended and Restated Credit Facility as of March 31, 2014. The Company has no outstanding balance under the Amended and Restated Credit Facility as of March 31, 2014.

Note Ten Loss Per Share

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

(In millions)	For the Three Months Ended	
	March 31,	March 31,
	2014	2013
Net loss	\$ (4.0)	\$ (3.7)
Dividends related to Series B Stock ⁽¹⁾	(0.1)	(0.1)
Net loss available to Common Stock holders	\$ (4.1)	\$ (3.8)
Per common share:		
Basic/diluted net loss available to Common Stock holders	\$ (0.22)	\$ (0.23)
 (In thousands)		
Weighted average shares of Common Stock outstanding	18,503	16,320
Currently antidilutive Common Stock equivalents ⁽²⁾	2,169	1,655

- (1) The Board of Directors did not declare a dividend payment on the 7% Series B Convertible Preferred Stock, par value \$0.01 per share (the Series B Stock), which was accrued, for the dividend periods July 1, 2012 through December 31, 2012, January 1, 2013 through June 30, 2013, and July 1, 2013 through December 31, 2013 (the

- cash dividend rate is \$0.1785 and the aggregate amount of these dividends was approximately \$0.9 million).
- (2) In periods in which there was a loss, the effect of Common Stock equivalents, which is primarily related to the Series B Stock, was not included in the diluted loss per share calculation as it was antidilutive.

Note Eleven Leases***Capital Leases***

The Company acquired \$0.4 million and \$0.8 million of computer equipment and leasehold improvements using capital leases during the first three months of 2014 and 2013, respectively. These assets were related primarily to investments in Behavioral Analytics. There was \$0.4 million and \$0.6 million of depreciation on capital leases in the first three months of 2014 and 2013, respectively. All capital leases are for a term of twenty-four, thirty, or thirty-six months. The liabilities for these capital leases are included in Other current liabilities and Other long-term liabilities on the balance sheet.

The following is a schedule, by year, of future minimum lease payments under capital leases, together with the present value of the net minimum lease payments as of March 31, 2014:

(In millions)	
Year	Amount
2014	\$ 1.5
2015	1.5
2016	0.3
2017	
Total minimum lease payments	\$ 3.3
Less: estimated executory costs	(0.2)
Net minimum lease payments	\$ 3.1
Less: amount representing interest	(0.3)
Present value of minimum lease payments	\$ 2.8

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(In millions)	March 31,	As of December 31,
	2014	2013
Other current liabilities	\$ 1.6	\$ 1.6
Other long-term liabilities	1.2	1.2
Total	\$ 2.8	\$ 2.8

Note Twelve Other Current Liabilities

(In millions)	March 31,	As of December 31,
	2014	2013
Capital leases	\$ 1.6	\$ 1.6
Warrant liability	1.2	0.8
Series B Stock dividend payable	1.0	0.9
Other	0.9	0.8
Total	\$ 4.7	\$ 4.1

Note Thirteen Stock Warrants

During the third quarter of 2013, the Company granted to PfG, certain affiliates of PfG, and Silicon Valley Bank warrants (collectively, the PfG Warrants) to purchase up to \$600 thousand of Common Stock. The PfG Warrants were issued in connection with the execution of the Credit Facility, and the Company received approximately \$4 thousand in connection with such issuance, which the parties agreed was fair consideration for the PfG Warrants.

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

The Company also granted warrants to PfG (the Conditional Warrants) to purchase up to \$2.0 million of Common Stock, which may be exercised, at the same exercise price as is specified for the Convertible Notes, only if both (i) the Tranche B Facility is advanced and (ii) the Company prepays the Tranche B Facility, in whole or in part, prior to the maturity date thereof. The Conditional Warrants may be exercised only in an amount equal to the principal amount of such prepayment. As of March 31, 2014, the Tranche B Facility had not been advanced.

The PfG Warrants and the Conditional Warrants, and the shares of Common Stock to be issued upon exercise of the PfG Warrants and the Conditional Warrants, have not been and will not be registered under the Securities Act of 1933, as amended, or any state securities law and were issued pursuant to an exemption from registration provided by Section 4(2) of the Securities Act and/or Regulation D promulgated thereunder. Neither the PfG Warrants and the

Conditional Warrants, nor the shares of Common Stock issuable upon exercise of the PfG Warrants and the Conditional Warrants, may be subsequently offered or sold within the United States absent registration or exemption from such registration requirements and compliance with applicable state laws. The warrant liability as of March 31, 2014 and December 31, 2013 was \$1.2 million and \$0.8 million, respectively.

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A summary of the status of the Warrants at March 31, 2014, and the changes during the three months, is presented in the following table:

	Issue Date	Shares of Common Stock, par value \$0.01, represented by Warrants	Exchange Price	Expiration Date
Granted	August 19, 2013	215,064	Lower of \$2.79 and 10-day VWAP at the Issue Date plus 6 months, subject to adjustment	August 19, 2018
Exercised				
Expired				
Outstanding as of December 31, 2013		215,064	Lower of \$2.79 and 10-day VWAP at the Issue Date plus 6 months, subject to adjustment	August 19, 2018
Granted				
Exercised				
Expired				
Outstanding as of March 31, 2014		215,064	Lower of \$2.79 and 10-day VWAP at the Issue Date plus 6 months, subject to adjustment	August 19, 2018
Exercisable as of March 31, 2014		215,064	Lower of \$2.79 and 10-day	August 19, 2018

VWAP at the Issue
Date plus 6 months,
subject to
adjustment

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

	March 31, 2014	December 31, 2013
Risk-free interest rates	1.48%	1.57%
Expected dividend yield		
Expected volatility	57%	58%
Expected lives	4.4 years	5.0 years
Weighted average grant date fair value	\$ 5.37	\$ 3.65

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

Note Fifteen Fair Value Measurements

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

The following table provides the assets and liabilities carried at fair value measured on a recurring basis as of March 31, 2014 and December 31, 2013:

(In millions)	Fair Value Measurements at March 31, 2014 Using			
	Total carrying value at March 31, 2014	Quoted Prices in Active Markets (Level 1)	Other Observable (Level 2)	Significant Unobservable (Level 3)
Money market fund	\$ 7.9	\$ 7.9	\$	\$
Warrant liability	\$ 1.2	\$	\$	\$ 1.2

(In millions)	Fair Value Measurements at December 31, 2013 Using			
	Total carrying value at December 31, 2013	Quoted Prices in Active Markets (Level 1)	Other Observable (Level 2)	Significant Unobservable (Level 3)
Money market fund	\$ 12.7	\$ 12.7	\$	\$
Warrant liability	\$ 0.8	\$	\$	\$ 0.8

The following table represents the activity in the Company's Level 3 warrants:

(In millions)	Amount
Level 3 warrants, end of period at December 31, 2013	\$ 0.8
Change in fair value of warrant liability	0.4
Level 3 warrants, end of period at March 31, 2014	\$ 1.2

Note Sixteen Fair Value of Financial Instruments

The carrying values of cash and cash equivalents, accounts receivable, and accounts payable approximated their fair values as of March 31, 2014 and December 31, 2013 due to the short-term nature of these instruments.

Note Seventeen Recent Accounting Pronouncements

In July 2013, the Financial Accounting Standards Board (FASB) issued ASU No. 2013-11, Income Taxes (Topic 740) Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Carryforward Exists. ASU 2013-11 provides guidance on the financial statement presentation of an unrecognized tax benefit when a net operating loss carryforward, a similar tax loss, or a tax credit carryforward exists. An unrecognized tax benefit should be presented in the financial statements as a reduction to a deferred tax asset for a net operating loss carryforward, a similar tax loss, or a tax credit carryforward with certain exceptions, in which case such an unrecognized tax benefit should be presented in the financial statements as a liability. The amendments in this ASU are effective for reporting periods beginning after December 15, 2013. The adoption of this ASU did not have a material impact on the Company's condensed consolidated financial statements.

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Note Eighteen Litigation and Other Contingencies

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

Under its By-Laws, subject to certain exceptions, the Company has agreed to indemnify its officers and directors for certain events or occurrences while the officer or director is, or was, serving at its request in such capacity or in certain related capacities. The Company has separate indemnification agreements with each of its directors and officers that requires it, subject to certain exceptions, to indemnify them to the fullest extent authorized or permitted by its By-Laws and the Delaware General Corporation Law. The maximum potential amount of future payments the Company could be required to make under these indemnification agreements is unlimited; however, the Company has a director and officer liability insurance policy that limits its exposure and enables it to recover a portion of any amounts paid under these indemnification agreements. As a result of its insurance policy coverage, the Company believes the estimated fair value of these indemnification agreements is minimal. The Company had no liabilities recorded for these agreements as of March 31, 2014.

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

Background

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

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

- (1) Managed services revenue, which is recurring, annuity revenue from long-term (generally three- to five-year) contracts and pilots, which are shorter-term (generally three to twelve months), and includes subscription and amortized deployment revenue; and

- (2) Consulting services revenue, which is generally project-based and sold on a time-and-materials or fixed-fee basis and includes follow-on consulting services revenue.

Set forth below is a more detailed description of the Company's current Behavioral Analytics offerings.

Behavioral Analytics

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

Identify optimal customer/employee behavioral pairing for call routing;

Identify and understand customer personality;

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

Improve rapport between agent and customer;

Reduce call handle times while improving customer satisfaction;

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Identify opportunities to improve self-service applications;

Improve cross-sell and up-sell success rates;

Improve the efficiency and effectiveness of collection efforts;

Measure and improve supervisor effectiveness and coaching;

Improve agent effectiveness by analyzing key attributes of desktop usage;

Predict likelihood of customer attrition;

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

Predict likelihood of debt repayment;

Predict likelihood of a sale or cross-sell; and

Identify fraud callers and improve authentication processes.

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

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

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

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

Types of Revenue

Managed Services Revenue

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

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

Consulting Services Revenue

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

Business Outlook

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

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

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

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

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

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

Continue bookings growth and improve operating leverage; and

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

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

Critical Accounting Policies and Estimates

Our management's discussion and analysis of financial condition and results of operations is based upon our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America (GAAP). The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenue, and expenses, and related disclosure of contingent assets and liabilities. On an ongoing basis, we evaluate our estimates, including those related to the costs and timing of completion of client projects, our ability to collect accounts receivable, the timing and amounts of expected payments associated with cost reduction activities, and the ability to realize our net deferred tax assets, contingencies, and litigation. We base our estimates on historical experience and on various other assumptions that we believe to be reasonable under the circumstances. Actual results may differ from these estimates under different assumptions or conditions.

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

Revenue Recognition

Behavioral Analytics Revenue

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

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

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

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

Other Revenue

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

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

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

Reimbursed Expenses

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

Unearned Revenues

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

Allowance for Doubtful Accounts

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

Stock-Based Compensation

Stock-based compensation cost is measured at the grant date based on the fair value of the award and is recognized as expense over the vesting period. Determining fair value of stock-based awards at the grant date requires certain assumptions. The Company uses historical information as the basis for the selection of expected life, expected volatility, expected dividend yield assumptions, and anticipated forfeiture rates. The risk-free interest rate is selected

based on the yields from U.S. Treasury Strips with a remaining term equal to the expected term of the options being valued.

Severance and Related Costs

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

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Income Taxes

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

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

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

Other Significant Accounting Policies

For a description of the Company's other significant accounting policies, see Note Two Summary of Significant Accounting Policies of the Notes to Consolidated Financial Statements included in our Annual Report filed on Form 10-K for the year ended December 31, 2013.

Forward-Looking Statements

Statements in this Form 10-Q that are not historical facts are forward-looking statements and are made pursuant to the safe harbor provisions of Section 27A of the Securities Act, and Section 21E of the Securities Exchange Act of 1934, as amended (the Exchange Act). These forward-looking statements, which may be identified by use of words such as plan, may, might, believe, expect, intend, could, would, should, and other words and terms of similar connection with any discussion of our prospects, financial statements, business, financial condition, revenues, results of operations, or liquidity, involve risks and uncertainties that could cause actual results to differ materially from those described in the forward-looking statements. In addition to other factors and matters contained or incorporated in this Quarterly Report on Form 10-Q, important factors that could cause actual results or events to differ materially from those indicated by such forward-looking statements include, without limitation, those noted under Risk Factors included in Part I Item 1A of our Form 10-K for the year ended December 31, 2013, as well as the following:

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

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

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

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

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

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

First Quarter of 2014 Compared with First Quarter of 2013

Services Revenue

Services revenue is total revenue excluding reimbursable expenses that are billed to our clients. Our services revenue decreased \$1.5 million, or 18%, to \$7.0 million in the first quarter of 2014, from \$8.5 million in the first quarter of 2013. The \$1.5 million decrease in Behavioral Analytics revenue in the first quarter of 2014 was primarily due to the previously announced expiration of our contract with Vangent, Inc. on December 31, 2013.

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Behavioral Analytics revenue was \$6.7 million in the first quarter of 2014 and \$8.2 million in the first quarter of 2013. The \$1.5 million, or 18%, decrease in Behavioral Analytics revenue in the first quarter of 2014 was also primarily due to the previously announced expiration of our contract with Vangent, Inc. on December 31, 2013.

Other revenue decreased by \$0.1 million, or 28%, to \$0.2 million in the first quarter of 2014, from \$0.3 million in the first quarter of 2013.

The Company's top five clients accounted for 74% of total revenue in the first quarter of 2014 and 64% of total revenue in the first quarter of 2013. The top 10 clients accounted for 91% of total revenue in the first quarter of 2014 and 90% of total revenue in the first quarter of 2013. In the first quarter of 2014 and 2013, there were four clients that accounted for 10% or more of total revenue. In the first quarter of 2014, Progressive Casualty Insurance Company, United HealthCare Services, Inc., HealthCare Service Corporation, and Allstate Insurance Company accounted for 22%, 21%, 11%, and 11% of total revenue, respectively. In the first quarter of 2013, Vangent, Inc., Allstate Insurance Company, Progressive Casualty Insurance Company, and United HealthCare Services, Inc., accounted for 18%, 14%, 13%, and 10% of total revenue, respectively. Higher concentration of revenue with a single client or a limited group of clients creates increased revenue risk if one of these clients significantly reduces its demand for our services.

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

Cost of Services

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

Cost of Behavioral Analytics revenue was \$2.1 million, or 31% of Behavioral Analytics revenue in the first quarter of 2014, compared to \$2.7 million, or 33% of Behavioral Analytics revenue, in the first quarter of 2013. The favorable decrease in cost and percentage was primarily due to improved productivity in our Delivery organization resulting in lower compensation costs, better leverage of our cost structure supporting our subscription clients, and by the decline in revenue.

Cost of other revenue was \$0.1 million, or 44% of Other revenue in the first quarter of 2014, compared to \$0.2 million, or 48% of Other revenue, in the first quarter of 2013.

Sales, Marketing and Development

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

Sales, marketing and development expenses decreased \$1.0 million, or 16%, to \$5.2 million in the first quarter of 2014 from \$6.2 million in the first quarter of 2013. This decrease is primarily due to lower compensation expense including lower commission expense due to reduced revenue.

General and Administrative

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

technology infrastructure and applications.

General and administrative expenses remained constant at \$2.3 million in the first quarter of both 2014 and 2013.

Depreciation and Amortization

Depreciation and amortization decreased \$0.3 million, or 23%, to \$0.7 million in the first quarter of 2014 from \$1.0 million in the first quarter of 2013. The decrease is due to capital lease disposals and assets that became fully depreciated near the end of 2013.

Operating Loss

Primarily as a result of the factors described above, we experienced an operating loss of \$3.4 million for the first quarter of 2014, compared to an operating loss of \$3.8 million for the first quarter of 2013, or a 10% improvement.

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Interest and Other Expense, Net

Interest and other expense was \$0.5 million of expense in the first quarter of 2014 compared to \$0.1 million of expense in the first quarter of 2013. The \$0.4 million increase was primarily related to increases in the fair value of our warrant liability and capital lease obligations.

Income Tax (Provision) Benefit

The income tax provision was less than \$0.1 million in the first quarter of 2014 and the tax benefit was \$0.2 million in the first quarter of 2013. The income tax benefit in the first quarter of 2013 was due to a favorable tax ruling on a previously accrued income tax liability. As of March 31, 2014, total net deferred tax assets of \$69.0 million were fully offset by a valuation allowance. The level of uncertainty in predicting when we will achieve profitability, sufficient to utilize our net U.S. and non-U.S. operating losses and realize our remaining deferred tax assets, requires that an income tax valuation allowance be recognized in the financial statements.

Net Loss Available to Common Stockholders

We reported net loss available to holders of Common Stock of \$4.1 million in the first quarter of 2014 compared to net loss available to holders of Common Stock of \$3.8 million in the first quarter of 2013. Accrued dividends to holders of Series B Stock were \$0.1 million in the first quarter of both 2014 and 2013. In the first quarter of 2014, there was net loss of \$0.22 per share on a basic and diluted basis, compared to net loss of \$0.23 per share on a basic and diluted basis in the first quarter of 2013.

Liquidity and Capital Resources

Introduction

Our principal capital requirements are to fund working capital needs, capital expenditures for Behavioral Analytics and infrastructure requirements, and other revenue generation and growth investments. As of March 31, 2014, our principal capital resources consisted of our cash and cash equivalents balance of \$8.1 million, which includes \$0.2 million in foreign bank accounts.

The decrease in cash during the first three months of 2014 was primarily the result of the net loss before non-cash items, payment of Company bonuses, a decrease in unearned revenue reflecting the recognition of previously deferred revenue, capital lease principal payments, capital expenditures, and the acquisition of treasury stock.

The decrease in cash during the first three months of 2013 was primarily the result of the net loss before non-cash items, capital lease principal payments, capital expenditures, and the acquisition of treasury stock.

Cash Flows from Operating Activities

Net cash used in operating activities during the first three months of 2014 and 2013 was \$4.2 million and \$0.9 million, respectively. During the first three months of 2014, net cash used in operating activities consisted primarily of the net loss before non-cash items of \$1.8 million and a \$1.5 million decrease in unearned revenue reflecting the recognition of previously deferred revenue.

During the first three months of 2013, cash outflows of \$0.9 million from operating activities consisted primarily of the net loss before non-cash items of \$1.3 million and a \$0.6 million increase in receivables reflecting an increase in

Days Sales Outstanding (DSO), offset by an increase of \$1.0 million in net customer prepayments.

DSO was 31 days at March 31, 2014, compared to 23 days at December 31, 2013, an increase of eight days. Because a high percentage of our revenue is dependent on a relatively small number of clients, delayed payments by a few of our larger clients could result in a reduction of our available cash, which in turn may cause fluctuation in our DSO. We do not expect any significant collection issues with our clients; see [Accounts Receivable Customer Concentration](#) for additional information on cash collections.

Cash Flows from Investing Activities

The Company used \$0.1 million of cash in investing activities during the first three months of 2014 compared to \$0.3 million of cash in investing activities during the first three months of 2013.

Capital expenditures were primarily used to purchase computer hardware and software during the first three months of 2014 and 2013. We currently expect to incur new capital investments of between \$4.0 million and \$5.0 million for fiscal year 2014 and plan on funding approximately \$3.0 million to \$3.8 million of these purchases with capital leases.

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Cash Flows from Financing Activities

Net cash used in financing activities was \$0.9 million during the first three months of 2014 compared to \$0.8 million during the first three months of 2013. The \$0.9 million of net cash used during the first three months of 2014 was primarily attributable to a \$0.4 million principal payment under our capital lease obligations and \$0.5 million of cash used to acquire treasury stock to meet employee tax obligations associated with the Company's stock-based compensation programs.

Net cash outflows of \$0.8 million during the first three months of 2013 were primarily attributable to \$0.6 million of principal payments under our capital lease obligations and \$0.2 million of cash used to acquire treasury stock.

Historically, we have not paid cash dividends on our Common Stock, and we do not expect to do so in the future. The Board of Directors did not declare a dividend payment on Series B Stock, which was accrued, for the dividend periods July 1, 2012 through December 31, 2012, January 1, 2013 through June 30, 2013, and July 1, 2013 through December 31, 2013 (the aggregate amount of these dividends was approximately \$0.9 million). A cash dividend on the Series B Stock of \$0.3 million was paid on January 3, 2012, for the dividend period July 1, 2011 through December 31, 2011, and a cash dividend of \$0.3 million was paid on July 2, 2012, for the dividend period January 1, 2012 through June 30, 2012. Under the terms of the Certificate of Designations for the Series B Stock, unpaid dividends are cumulative and accrue at the rate of 7% per annum, payable semi-annually in January and July. The amount of each dividend accrual will be decreased by any conversions of the Series B Stock into Common Stock, as such conversions require the Company to pay accrued but unpaid dividends at the time of conversion. Conversions of Series B Stock became permissible at the option of the holder after June 19, 2002.

The Company expects to acquire between \$0.1 million and \$0.2 million of treasury stock during the second quarter of 2014 to meet employee tax obligations associated with the Company's stock-based compensation programs.

Liquidity

Our near-term capital resources consist of our current cash balance, together with anticipated future cash flows, financing from capital leases, and our revolving lines of credit (See *Credit Facility* below). Our balance of cash and cash equivalents was \$8.1 million as of March 31, 2014.

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

Partners for Growth Credit Facility

On August 19, 2013, the Company, together with its wholly-owned subsidiaries Mattersight Europe Holding Corporation and Mattersight International Holding, Inc., as co-borrowers, entered into a Loan and Security Agreement with Partners for Growth IV, L.P. (*PfG*) (the *Credit Facility*). The Credit Facility is subordinated to the Company's \$10.0 million credit facility with Silicon Valley Bank (described below) and, in combination therewith, brings the Company's aggregate lines of credit to \$15.0 million. The Credit Facility provides for (a) a \$3.0 million revolving line

of credit maturing in 2016 (the Tranche A Facility) and (b) a \$2 million convertible term loan (the Tranche B Facility), which, if advanced, would be funded in two tranches of \$1.0 million, each evidenced by a convertible promissory note (each, a Convertible Note) maturing five years following the issuance thereof. Each Convertible Note would convert, at the option of the holder, into Common Stock at an exercise price of at least the 10-day volume weighted average per share of Common Stock (10-Day VWAP) as of the date on which such Note is issued. If issued, the Convertible Notes, and the shares of Common Stock to be issued upon exercise of the Convertible Notes, will not be registered under the Securities Act of 1933, as amended, or any state securities law and will be issued pursuant to an exemption from registration provided by Section 4(2) of the Securities Act and/or Regulation D promulgated thereunder. Neither the Convertible Notes, nor the shares of Common Stock issuable upon exercise of Convertible Notes, may be subsequently offered or sold within the United States absent registration or exemption from such registration requirements and compliance with applicable state laws. The Company has not drawn on the Credit Facility as of March 31, 2014.

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With respect to the Tranche A Facility, upon entering into the Credit Facility in August 2013, the Company paid a commitment fee of \$60 thousand, equal to two percent (2.0%) of the Tranche A Facility commitment, and will pay an annual commitment fee of one percent (1.0%) of the Tranche A Facility commitment in each of 2014 and 2015. With respect to the Tranche B Facility, upon entering into the Credit Facility in August 2013, the Company paid a commitment fee of \$20 thousand, equal to one percent (1.0%) of the Tranche B Facility commitment, and will pay one percent (1.0%) of the Tranche B Facility commitment upon the advance of each Convertible Note. Furthermore, the principal amount outstanding under the Credit Facility, if drawn upon, will accrue interest at a fixed annual rate equal to nine and three quarters percent (9.75%) per annum, payable monthly, which, if the Company meets certain earnings and EBITDA targets, will be reduced to eight and three quarters percent (8.75%) per annum, payable monthly.

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

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

Silicon Valley Bank Credit Facility

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

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The Company has no outstanding balance under the Amended and Restated Credit Facility as of March 31, 2014. Through the maturity date, the Company is obligated to pay a fee equal to one-eighth of one percent (0.125%) per annum of the average unused portion of the Amended and Restated Credit Facility, payable quarterly in arrears.

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

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

Accounts Receivable Customer Concentration

As of March 31, 2014, two clients, United HealthCare Services, Inc. and CVS Caremark Corporation, accounted for 34% and 17% of total gross accounts receivable, respectively. Of these amounts, we have collected 8% from United HealthCare Services, Inc. and 51% from CVS Caremark Corporation through May 5, 2014. Of the total March 31, 2014 gross accounts receivable, we have collected 20% as of May 5, 2014. Because we have a high percentage of our revenue dependent on a relatively small number of clients, delayed payments by a few of our larger clients could result in a reduction of our available cash.

Capital Lease Obligations

Capital lease obligations were \$2.8 million as of March 31, 2014 and December 31, 2013. We are a party to a capital lease agreement with a leasing company to lease hardware and software. We expect to incur new capital lease obligations of between \$3.0 million to \$3.8 million for fiscal year 2014 as we continue to expand our investment in the infrastructure for Behavioral Analytics.

Contractual Obligations

Cash will also be required for operating leases and non-cancellable purchase obligations, as well as various commitments reflected as liabilities on our balance sheet as of March 31, 2014. These commitments are as follows:

(In millions)		Less Than 1	1 - 3	3 - 5	More Than 5
Contractual Obligations	Total	Year	Years	Years	Years
Letters of credit	\$ 0.4	\$ 0.4	\$	\$	\$
Operating leases	2.3	1.5	0.8		
Capital leases	3.3	1.9	1.4		
Purchase obligations	1.0	1.0			
Total	\$ 7.0	\$ 4.8	\$ 2.2	\$	\$

Letters of Credit

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

Leases

The amounts set forth in the chart above reflect future principal, interest, and executory costs of the leases entered into by the Company for technology and office equipment, as well as office and data center space. Liabilities for the principal portion of the capital lease obligations are reflected on our balance sheet as of March 31, 2014 and December 31, 2013.

Purchase Obligations

Purchase obligations include \$1.0 million of commitments reflected as liabilities on our balance sheet as of March 31, 2014, as well as \$0.4 million of non-cancellable obligations to purchase goods or services in the future. As of December 31, 2013, purchase obligations include \$0.9 million of commitments reflected as liabilities on our balance sheet, as well as \$0.6 million of non-cancellable obligations to purchase goods or services in the future.

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Recent Accounting Pronouncements

In July 2013, the Financial Accounting Standards Board (FASB) issued ASU No. 2013-11, Income Taxes (Topic 740)

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

Item 3. Quantitative and Qualitative Disclosures about Market Risk

There have been no material changes in market risk as of March 31, 2014 from that described in the Company s Annual Report filed on Form 10-K for the year ended December 31, 2013.

Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

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

As of the last business day of our second fiscal quarter of 2013 (i.e., June 30, 2013), our public float, as calculated in accordance with Rule 12b-2 under the Securities Exchange Act of 1934, as amended (Rule 12b-2), was less than \$50 million. As such, we became a smaller reporting company (as defined in Rule 12b-2) on such date.

Changes in Internal Control over Financial Reporting

There has been no change in Mattersight s internal control over financial reporting that occurred during the first quarter of 2014 that has materially affected, or is reasonably likely to materially affect, Mattersight s internal control over financial reporting.

Part II. Other Information

Item 1. Legal Proceedings

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

Item 1A. Risk Factors

There have been no material changes with respect to the factors disclosed in our Annual Report filed on Form 10-K for the year ended December 31, 2013.

Table of Contents**Item 2. Unregistered Sales of Equity Securities and Use of Proceeds*****Repurchase of Equity Securities***

The following table provides information relating to the Company's purchase of shares of its Common Stock in the first quarter of 2014. All of these purchases reflect shares withheld to satisfy tax withholding obligations related to vesting of restricted stock. The Company has not adopted a Common Stock repurchase plan or program.

Period	Total Number of Shares Purchased	Average Price Paid Per Share
January 1, 2014 - January 31, 2014		\$
February 1, 2014 - February 28, 2014	97,272	\$ 5.64
March 1, 2014 - March 31, 2014		\$
Total	97,272	\$ 5.64

Item 6. Exhibits

- **31.1 Certification of Kelly D. Conway under Section 302 of the Sarbanes-Oxley Act of 2002.
- **31.2 Certification of Mark Iserloth under Section 302 of the Sarbanes-Oxley Act of 2002.
- **32.1 Certification of Kelly D. Conway and Mark Iserloth under Section 906 of the Sarbanes-Oxley Act of 2002.
- **101 The following materials from our Quarterly Report on Form 10-Q for the quarter ended March 31, 2014 are formatted in eXtensible Business Reporting Language (XBRL): (i) Condensed Consolidated Balance Sheets as of March 31, 2014 and December 31, 2013, (ii) Condensed Consolidated Statements of Operations for the three months ended March 31, 2014 and March 31, 2013, (iii) Condensed Consolidated Statements of Comprehensive Loss for the three months ended March 31, 2014 and March 31, 2013, (iv) Condensed Consolidated Statements of Cash Flows for the three months ended March 31, 2014 and March 31, 2013, and (v) Notes to the Unaudited Condensed Consolidated Financial Statements.

** Filed herewith.

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SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized, on May 8, 2014.

MATTERSIGHT CORPORATION

By /s/ MARK ISERLOTH

Mark Iserloth
Vice President and Chief Financial Officer
(Duly authorized signatory and
Principal Financial Officer)

By /s/ GLENN H. POLSON

Glenn H. Polson
Vice President of Financial Reporting
(Duly authorized signatory and
Principal Accounting Officer)