

SERVICESOURCE INTERNATIONAL, INC.

Form 10-Q

August 05, 2013

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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended June 30, 2013

OR

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number 001-35108

SERVICESOURCE INTERNATIONAL, INC.

(Exact name of registrant as specified in our charter)

Delaware

No. 81-0578975

(State or Other Jurisdiction of

(I.R.S. Employer

Incorporation or Organization)

Identification No.)

634 Second Street

94107

San Francisco, California

(Address of Principal Executive Offices)

(Zip Code)

(415) 901-6030

(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 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or 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. (Check one):

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

Indicate number of shares outstanding of each of the issuer's classes of common stock, as of the latest practical date:

Class

Outstanding as of July 30, 2013

Common Stock

79,411,505

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## PART I FINANCIAL INFORMATION

## Item 1. Financial Statements

SERVICESOURCE INTERNATIONAL, INC.  
CONDENSED CONSOLIDATED BALANCE SHEETS

(In thousands)

(Unaudited)

	June 30, 2013	December 31, 2012
Assets		
Current assets:		
Cash and cash equivalents	\$77,403	\$76,568
Short-term investments	54,649	32,874
Accounts receivable, net	60,894	65,238
Deferred income taxes	177	389
Prepaid expenses and other	6,661	5,178
Total current assets	199,784	180,247
Property and equipment, net	30,275	34,513
Deferred income taxes, net of current portion	1,986	2,321
Other assets, net	794	1,057
Goodwill	6,334	6,334
Total assets	\$239,173	\$224,472
Liabilities and Stockholders' Equity		
Current liabilities:		
Accounts payable	\$2,505	\$3,293
Accrued taxes	1,801	1,056
Accrued compensation and benefits	18,873	15,738
Accrued liabilities and other	13,640	10,403
Obligations under capital leases	328	326
Total current liabilities	37,147	30,816
Obligations under capital leases, net of current portion	466	638
Other long-term liabilities	4,839	6,091
Total liabilities	42,452	37,545
Commitments and contingencies (Note 7)		
Stockholders' equity:		
Common stock; \$0.0001 par value; 1,000,000 shares authorized; 79,099 shares issued and 79,220 shares outstanding as of June 30, 2013; 75,758 shares issued and 75,637 shares outstanding as of December 31, 2012	8	8
Treasury stock	(441	) (441
Additional paid-in capital	235,714	210,650
Accumulated deficit	(38,759	) (23,398
Accumulated other comprehensive income	199	108
Total stockholders' equity	196,721	186,927
Total liabilities and stockholders' equity	\$239,173	\$224,472

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

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SERVICESOURCE INTERNATIONAL, INC.  
 CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS  
 (In thousands, except per share amounts)  
 (Unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2013	2012	2013	2012
Net revenue	\$67,697	\$59,694	\$128,818	\$117,268
Cost of revenue	38,620	33,882	77,118	66,458
Gross profit	29,077	25,812	51,700	50,810
Operating expenses:				
Sales and marketing	15,367	14,169	30,175	27,646
Research and development	6,794	4,298	13,042	8,879
General and administrative	10,783	10,564	22,004	20,639
Total operating expenses	32,944	29,031	65,221	57,164
Loss from operations	(3,867 )	(3,219 )	(13,521 )	(6,354 )
Other expense, net	(295 )	(333 )	(403 )	(424 )
Loss before income taxes	(4,162 )	(3,552 )	(13,924 )	(6,778 )
Income tax provision	744	33,217	1,437	31,267
Net loss	\$(4,906 )	\$(36,769 )	\$(15,361 )	\$(38,045 )
Net loss per common share:				
Basic	\$(0.06 )	\$(0.50 )	\$(0.20 )	\$(0.52 )
Diluted	(0.06 )	(0.50 )	(0.20 )	(0.52 )
Weighted-average shares used in computing net loss per common share:				
Basic	77,275	74,172	76,447	73,654
Diluted	77,275	74,172	76,447	73,654

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

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CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE LOSS

(In thousands)

(Unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2013	2012	2013	2012
Net loss	\$ (4,906	) \$ (36,769	) \$ (15,361	) \$ (38,045
Other comprehensive income (loss), net of tax:				
Foreign currency translation adjustments	146	(56	) 211	(73
Unrealized gain (loss) on short-term investments, net of tax	(151	) (14	) (120	) 26
Other comprehensive income (loss), net of tax	(5	) (70	) 91	(47
Total comprehensive loss, net of tax	\$ (4,911	) \$ (36,839	) \$ (15,270	) \$ (38,092

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

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SERVICESOURCE INTERNATIONAL, INC.  
 CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS  
 (In thousands)  
 (Unaudited)

	Six Months Ended June 30,	
	2013	2012
Cash flows from operating activities		
Net loss	\$(15,361	) \$(38,045
Adjustments to reconcile net loss to net cash provided by operating activities:		
Depreciation and amortization	6,028	4,576
Provision for doubtful accounts	(149	) —
Amortization of deferred financing costs	24	123
Accretion on premium on short-term investments	347	445
Deferred income taxes	545	32,220
Stock-based compensation	11,343	9,607
Income tax charge from stock-based compensation	264	362
Changes in operating assets and liabilities:		
Accounts receivable	4,189	2,586
Prepaid expenses and other	(1,204	) (811
Accounts payable	(558	) (877
Accrued taxes	752	298
Accrued compensation and benefits	3,291	(4,820
Accrued liabilities and other	2,156	4,145
Net cash provided by operating activities	11,667	9,809
Cash flows from investing activities		
Acquisition of property and equipment	(2,224	) (11,244
Purchases of short-term investments	(26,647	) (24,186
Sales of short-term investments	3,154	6,210
Maturities of short-term investments	1,250	11,820
Net cash used in investing activities	(24,467	) (17,400
Cash flows from financing activities		
Repayment on capital leases obligations	(161	) (155
Proceeds from common stock issuances	13,612	7,818
Income tax charge from stock-based compensation	(264	) (362
Net cash provided by financing activities	13,187	7,301
Net increase (decrease) in cash and cash equivalents	387	(290
Effect of exchange rate changes on cash and cash equivalents	448	(107
Cash and cash equivalents at beginning of period	76,568	65,983
Cash and cash equivalents at end of period	\$77,403	\$65,586

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

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SERVICESOURCE INTERNATIONAL, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Note 1 — Description of Business and Basis of Presentation

ServiceSource is the global leader in recurring revenue management, partnering with technology and technology-enabled companies to optimize maintenance, support and subscription revenue streams, while also improving customer relationships and loyalty. The Company delivers these results via a cloud-based solution, with dedicated service teams, leveraging benchmarks and best practices derived from their rich database of service and renewal behavior. By integrating software, managed services and data, the Company provides end-to-end management and optimization of the service-contract renewals process, including data management, quoting, selling and recurring revenue business intelligence. The Company receives commissions from its customers based on renewal sales that the Company generates on their behalf under a pay-for-performance model. In addition, the Company recently began to offer a purpose-built Software-As-A-Service (SaaS) application to maximize the renewal of subscriptions, maintenance and support contracts. The Company's corporate headquarters is located in San Francisco, California. The Company has additional offices in Colorado, Tennessee, the United Kingdom, Ireland, Malaysia and Singapore. The accompanying unaudited interim condensed consolidated financial statements ("condensed consolidated financial statements") include the accounts of ServiceSource International Inc. and its subsidiaries ("SSI" or "Company"). Intercompany accounts and transactions have been eliminated in consolidation.

These condensed consolidated financial statements have been prepared in accordance with generally accepted accounting principles in the United States ("U.S. GAAP" or "GAAP") for interim financial information, rules and regulations of the Securities and Exchange Commission ("SEC") for interim financial statements, and accounting policies, consistent in all material respects with those applied in preparing our audited annual consolidated financial statements included in our Annual Report on Form 10-K for the year ended December 31, 2012. These condensed consolidated financial statements and accompanying notes should be read in conjunction with our annual consolidated financial statements and the notes thereto for the year ended December 31, 2012, included in our Annual Report on Form 10-K. In the opinion of management, these condensed consolidated financial statements reflect all adjustments, including normal recurring adjustments, management considers necessary for a fair statement of our financial position, operating results, and cash flows for the interim periods presented. The results for the interim periods are not necessarily indicative of results for the entire year.

The December 31, 2012 condensed consolidated balance sheet data was derived from audited financial statements, but does not include all disclosures required by accounting principles generally accepted in the United States of America. These unaudited interim condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and related notes for the year ended December 31, 2012 included in the Company's Annual Report on Form 10-K.

Recent Accounting Pronouncements

In February 2013, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") No. 2013-2 "Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income." ASU No. 2013-2 requires an entity to disaggregate the total change of each component of other comprehensive income either on the face of the income statement or as a separate disclosure in the notes. The new guidance became effective for the Company's interim period ended March 31, 2013. The Company adopted this guidance and the adoption did not have any impact on its financial position, results of operations or cash flows as the amounts reclassified out of accumulated other comprehensive income is not material.

In June 2013, the Financial Accounting Standards Board determined that an unrecognized tax benefit should be presented as a reduction of a deferred tax asset for a net operating loss ("NOL") carryforward or other tax credit carryforward when settlement in this manner is available under applicable tax law. This guidance is effective for the Company's interim and annual periods beginning January 1, 2014. The Company does not believe the adoption of this guidance will have a material impact on its consolidated financial statements.

Note 2 — Cash, cash equivalents and short-term investments

Cash equivalents consist of highly liquid fixed-income investments with original maturities of three months or less at the time of purchase, including money market funds. Short-term investments consist of readily marketable securities with a remaining maturity of more than three months from time of purchase. The Company classifies all of its cash equivalents and short-term investments as “available for sale,” as these investments are free of trading restrictions. These marketable securities are carried at fair value, with the unrealized gains and losses, net of tax, reported as accumulated other comprehensive income and included as a separate component of stockholders’ equity. Gains and losses are recognized when realized. When the Company determines that an other-than-temporary decline in fair value has occurred, the amount of the decline that is related to



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a credit loss is recognized in earnings. Gains and losses are determined using the specific identification method. The Company's realized gains and losses in the three and six months ended June 30, 2013 and 2012 were insignificant. Cash and cash equivalents and short-term investments consisted of the following as of June 30, 2013 and December 31, 2012 (in thousands):

June 30, 2013

	Amortized Cost	Unrealized Gains	Unrealized Losses	Estimated Fair Value
Cash	\$45,706	\$—	\$—	\$45,706
Cash equivalents:				
Money market mutual funds	31,697	—	—	31,697
Total cash and cash equivalents	77,403	—	—	77,403
Short-term investments:				
Corporate bonds	21,471	6	(51	) 21,426
U.S. agency securities	21,126	2	(50	) 21,078
Asset-backed securities	6,669	—	(29	) 6,640
U.S. Treasury securities	5,514	—	(9	) 5,505
Total short-term investments	54,780	8	(139	) 54,649
Cash, cash equivalents and short-term investments	\$132,183	\$8	\$(139	) \$132,052

December 31, 2012

	Amortized Cost	Unrealized Gains	Unrealized Losses	Estimated Fair Value
Cash	\$59,568	\$—	\$—	\$59,568
Cash equivalents:				
Money market mutual funds	17,000	—	—	17,000
Total cash and cash equivalents	76,568	—	—	76,568
Short-term investments:				
Corporate bonds	13,389	2	(14	) 13,377
U.S. agency securities	11,280	4	(1	) 11,283
Asset-backed securities	4,670	1	(5	) 4,666
U.S. Treasury securities	3,546	2	—	3,548
Total short-term investments	32,885	9	(20	) 32,874
Cash, cash equivalents and short-term investments	\$109,453	\$9	\$(20	) \$109,442

The following table summarizes the cost and estimated fair value of short-term fixed income securities classified as short-term investments based on stated maturities as of June 30, 2013:

	Amortized Cost	Estimated Fair Value
Less than 1 year	\$5,098	\$5,097
Due in 1 to 5 years	49,682	49,552
Total	\$54,780	\$54,649

As of June 30, 2013, the Company did not consider any of its investments to be other-than-temporarily impaired.  
Note 3 — Fair value of financial instruments

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The Company measures certain financial instruments at fair value on a recurring basis. The Company uses a three-tier fair value hierarchy, which prioritizes the inputs used in the valuation methodologies in measuring fair value: Level 1 valuations are based on quoted prices in active markets for identical assets or liabilities.

Level 2 valuations are based on inputs that are observable, either directly or indirectly, other than quoted prices included within Level 1. Such inputs used in determining fair value for Level 2 valuations include quoted prices in active markets for similar assets or liabilities, quoted prices for identical or similar assets or liabilities in markets that are not active, or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities.

Level 3 valuations are based on information that is unobservable and significant to the overall fair value measurement. All of the Company's cash equivalents and short-term investments are classified within Level 1 or Level 2.

The following table presents information about the Company's financial instruments that are measured at fair value as of June 30, 2013 and indicates the fair value hierarchy of the valuation (in thousands):

Description	Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)
Cash equivalents:			
Money market mutual funds	\$31,697	\$31,697	\$—
Total cash equivalents	31,697	31,697	—
Short-term investments:			
Corporate bonds	21,426	—	21,426
U.S. agency securities	21,078	—	21,078
Asset-backed securities	6,640	—	6,639
U.S. Treasury securities	5,505	—	5,506
Total short-term investments	54,649	—	54,649
Cash equivalents and short-term investments	\$86,346	\$31,697	\$54,649

The following table presents information about the Company's financial instruments that are measured at fair value as of December 31, 2012 and indicates the fair value hierarchy of the valuation (in thousands):

Description	Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)
Cash equivalents:			
Money market mutual funds	\$17,000	\$17,000	\$—
Total cash equivalents	17,000	17,000	—
Short-term investments:			
Corporate bonds	13,377	—	13,377
U.S. agency securities	11,283	—	11,283
Asset-backed securities	4,666	—	4,666
U.S. Treasury securities	3,548	—	3,548

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Total short-term investments	32,874	—	32,874
Cash equivalents and short-term investments	\$49,874	\$17,000	\$32,874

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The Company did not have any financial liabilities measured at fair value as of June 30, 2013 or December 31, 2012.

## Note 4 — Property and Equipment, Net

Property and equipment balances were comprised of the following (in thousands):

	June 30, 2013	December 31, 2012
Computers and equipment	\$15,875	\$14,733
Software	33,317	32,982
Furniture and fixtures	8,660	8,555
Leasehold improvements	10,970	10,801
	68,822	67,071
Less: accumulated depreciation and amortization	(38,660	) (32,558
	30,162	34,513
Construction in progress	113	—
	\$30,275	\$34,513

Depreciation and amortization expense during the three and six months ended June 30, 2013 and the three and six months ended June 30, 2012, was \$2.8 million, \$6.0 million, \$2.3 million and \$4.6 million respectively.

Total property and equipment assets under capital lease at June 30, 2013 and December 31, 2012, was \$3.2 million and \$3.2 million, respectively. Accumulated depreciation related to assets under capital lease as of these dates were \$2.4 million and \$2.1 million, respectively.

The Company capitalized internal-use software development costs of \$0 and \$2.8 million during the three months ended June 30, 2013 and 2012, respectively and \$0 and \$5.0 million during the six months ended June 30, 2013 and 2012, respectively. As of June 30, 2013 and December 31, 2012, the carrying value of capitalized costs related to internal-use software, net of accumulated amortization, was \$11.1 million and \$13.6 million, respectively.

Amortization of capitalized costs related to internal-use software for the three months ended June 30, 2013 and 2012 was \$1.3 million and \$0.6 million, respectively, and for the six months ended June 30, 2013 and 2012 was \$2.5 million and \$1.3 million, respectively.

## Note 5 — Accrued Liabilities and Other

Accrued liabilities and other balances were comprised of the following (in thousands):

	June 30, 2013	December 31, 2012
Deferred revenue	\$3,955	\$2,295
Accrued operating expenses	3,633	3,664
Deferred rent obligations	887	986
Other employee related	394	323
Accrued other (includes ESPP contributions of \$763 and \$1,059 at June 30, 2013 and December 31, 2012, respectively)	4,771	3,135
	\$13,640	\$10,403

## Note 6 — Credit Facility and Capital Leases

## Revolving Credit Facility

On July 5, 2012, the Company, entered into a three-year credit agreement which provides for a secured revolving line of credit based on eligible accounts receivable of up to \$25.0 million on and before July 5, 2013 and up to \$30.0 million thereafter, in each case with a \$2.0 million letter of credit sublimit. On June 18, 2013, the Company elected to maintain the revolving commitment at \$25.0 million rather than have it increase to \$30 million on July 5, 2013.

Proceeds available under the agreement may be used for working capital and other general corporate purposes. The

Company may prepay borrowing under

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the agreement in whole or in part at any time without premium or penalty. The Company may terminate the commitments under the credit agreement in whole at any time, and may reduce the commitments by up to \$10.0 million between July 1, 2013 and June 30, 2014. On June 30, 2013, the Company amended the credit agreement to reduce the quarterly commitment fee, payable in arrears, based on the available commitments from the existing 0.45% rate to 0.30%.

Amounts outstanding on the facility at June 30, 2013 consisted of a letter of credit of \$575,000 as required under an operating lease agreement for office space at the Company's San Francisco headquarters. The loans bear interest, at the Company's option, at a base rate determined in accordance with the credit agreement, minus 0.5%, or at a LIBOR rate plus 2.0%. Principal, together with all accrued and unpaid interest, is due and payable on July 5, 2015, the maturity date. The Company is also obligated to pay a quarterly commitment fee, payable in arrears, based on the available commitments at a rate of 0.30%. At June 30, 2013, the interest rate for borrowings under the facility was 2.2%.

The credit agreement contains customary affirmative and negative covenants, as well as financial covenants. Affirmative covenants include, among others, delivery of financial statements, compliance certificates and notices of specified events, maintenance of properties and insurance, preservation of existence, and compliance with applicable laws and regulations. Negative covenants include, among others, limitations on the ability of the Company and its subsidiaries to grant liens, incur indebtedness, engage in mergers, consolidations and sales of assets and engage in affiliate transactions. The agreement requires the Company to maintain a maximum leverage ratio and a minimum liquidity amount, each as defined in the agreement.

The credit agreement also contains customary events of default including, among other things, payment defaults, breaches of covenants or representations and warranties, cross-defaults with certain other indebtedness, bankruptcy and insolvency events and change in control of the Company, subject to grace periods in certain instances. Upon an event of default, the lender may declare the outstanding obligations of the Company under the agreement to be immediately due and payable and exercise other rights and remedies provided for under the credit agreement.

The Company's obligations under the credit agreement are guaranteed by its subsidiary, ServiceSource Delaware, Inc. (the "Guarantor") and are collateralized by substantially all of the assets of the Company and the Guarantor. Effective June 29, 2012, the Company terminated a \$20.0 million credit facility. At the time of the termination, no borrowings were outstanding other than a letter of credit in the face amount of \$850,000.

Capital Leases

The Company has capital lease agreements that are collateralized by the underlying property and equipment and expire through September 2019. The weighted-average imputed interest rates for the capital lease agreements were 2.54% and 3.75% at June 30, 2013 and 2012, respectively.

Future minimum annual payments under capital lease obligations as of June 30, 2013 were as follows (in thousands):

	June 30, 2013
Years Ending	
2013 (remaining six months)	\$ 163
2014	266
2015	73
2016	75
2017	77
Thereafter	140
Total	\$ 794

Note 7 — Commitments and ContingenciesOperating Leases

The Company leases its office space and certain equipment under noncancelable operating lease agreements with various expiration dates through September 30, 2022. Rent expense for the three months ended June 30, 2013 and 2012 was \$2.1 million and \$2 million, respectively, and for the six months ended June 30, 2013 and 2012 was \$4.3 million and \$4.4 million, respectively. The Company recognizes rent expense on a straight-line basis over the lease

period and accrues for rent expense incurred but not paid.

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Future annual minimum lease payments under all noncancelable operating leases as of June 30, 2013 were as follows (in thousands):

	June 30, 2013
Years ending	
2013 (remaining six months).	\$4,473
2014	7,845
2015	5,967
2016	4,169
2017	4,004
Thereafter	12,526
Total	\$38,984

## Other Matters

The Company may be subject to litigation or other claims in the normal course of business. In the opinion of management, the Company's ultimate liability, if any, related to any currently pending or threatened litigation or claims would not materially affect its consolidated financial position, results of operations or cash flows.

## Note 8 — Stockholders' Equity

## Stock Option Plans

The Company maintains the following stock plans: the 2011 Equity Incentive Plan (the "2011 Plan"), and the 2011 Employee Stock Purchase Plan. The Company's board of directors and, as delegated to its compensation committee, administers the 2011 Plan and has authority to determine the directors, officers, employees and consultants to whom options or restricted stock may be granted, the option price or restricted stock purchase price, the timing of when each share is exercisable and the duration of the exercise period and the nature of any restrictions or vesting periods applicable to an option or restricted stock grant

Under the 2011 Plan, options granted are generally subject to a four-year vesting period whereby options become 25% vested after a one-year period and the remainder then vests monthly through the end of the vesting period. Vested options may be exercised up to ten years from the vesting commencement date, as defined in the 2011 Plan. Vested but unexercised options expire three months after termination of employment with the Company. The restricted stock units typically vest over four years with a yearly cliff contingent upon employment with the Company on the dates of vest.

The Company has elected to recognize the compensation cost of all stock-based awards on a straight-line basis over the vesting period of the award. Further, the Company applied an estimated forfeiture rate to unvested awards when computing the share compensation expenses. The Company estimated the forfeiture rate for unvested awards based on its historical experience on employee turnover behavior and other factors.

At the end of each fiscal year, the share reserve under the 2011 Plan will increase automatically by an amount equal to 4% outstanding shares as of the end of that most recently completed fiscal year or 3,840,000 shares, whichever is less. On January 1, 2013, 3.0 million additional shares were reserved under the 2011 Equity Incentive Plan pursuant to the automatic increase.

## Determining Fair Value of Stock Awards

The Company estimates the fair value of stock option awards at the date of grant using the Black-Scholes option-pricing model. Options are granted with an exercise price equal to the fair value of the common stock as of the date of grant. Compensation expense is amortized net of estimated forfeitures on a straight-line basis over the requisite service period of the options, which is generally four years. Restricted stock, upon vesting, entitles the holder to one share of common stock for each restricted stock and has a purchase price of \$0.0001 per share, which is equal to the par value of the Company's common stock, and vests over four years. The fair value of the restricted stock is based on the Company's closing stock price on the date of grant, and compensation expense, net of estimated forfeitures, is recognized on a straight-line basis over the vesting period.

The weighted average Black-Scholes model assumptions for the three and six months ended June 30, 2013 and 2012 were as follows:





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	Three Months Ended June 30,		Six Months Ended June 30,		
	2013	2012	2013	2012	
Expected term (in years)	5.0	5.1	5.0	5.1	
Expected volatility	44	% 45	% 44	% 45	%
Risk-free interest rate	0.84	% 0.83	% 0.85	% 0.82	%
Expected dividend yield	—	—	—	—	

Option and restricted stock activity under the 2011 Plan for the six months ended June 30, 2013 were as follows (shares in thousands)

	Shares and Units Available for Grant	Options Outstanding Number of Shares	Weighted-Average Exercise Price	Restricted Stock Outstanding Number of Shares
Outstanding — December 31, 2012	4,024	15,189	\$6.98	3,928
Additional shares reserved under the 2011 equity incentive plan	3,025	—	—	—
Granted	(3,910	) 2,093	7.05	1,817
Options exercised/ Restricted stock released	—	(2,951	) 7.36	(405
Canceled/Forfeited	4,469	(3,793	) 6.65	(676
Outstanding — June 30, 2013	7,608	10,538	5.30	4,664

The weighted average grant-date fair value of employee stock options granted during the three months ended June 30, 2013 and 2012 was \$2.67 and \$6.68 per share, respectively and for the six months ended June 30, 2013 and 2012 was \$2.68 and \$6.98 per share, respectively.

The following table summarizes the consolidated stock-based compensation expense included in the condensed consolidated statements of operations (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2013	2012	2013	2012
Cost of revenue	\$688	\$715	\$1,420	\$1,287
Sales and marketing	2,449	1,982	4,982	3,656
Research and development	519	530	1,005	893
General and administrative	1,767	2,133	3,936	3,771
Total stock-based compensation	\$5,423	\$5,360	\$11,343	\$9,607

## Employee Stock Purchase Plan

The Company's 2011 Employee Stock Purchase Plan (the "ESPP") is intended to qualify under Section 423 of the Internal Revenue Code of 1986. Under the ESPP, employees are eligible to purchase common stock through payroll deductions

of up to 10% of their eligible compensation, subject to any plan limitations. The purchase price of the shares on each purchase date is equal to 85% of the lower of the fair market value of the Company's common stock on the first and last trading days of each six-month offering period.

The Company estimates the fair value of purchase rights under the ESPP using the Black-Scholes valuation model. The fair value of each purchase right under the ESPP was estimated on the date of grant using the Black-Scholes option valuation model and the straight-line attribution approach with the following weighted-average assumptions:



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	Three Months Ended June 30, 2013	Three Months Ended June 30, 2012	Six Months Ended June 30, 2013	Six Months Ended June 30, 2012
Expected term (in years)	0.50	0.50	0.50	0.50
Expected volatility	27	% 45	% 27	% 45
Risk-free interest rate	0.13	% 0.13	% 0.13	% 0.13
Expected dividend yield	—	—	—	—

The ESPP provides that additional shares are reserved under the plan annually on the first day of each fiscal year in an amount equal to the lesser of (i) 1.5 million shares, (ii) one percent of the outstanding shares of common stock on the last day of the immediately preceding fiscal year, or (iii) an amount determined by the board of directors and/or the compensation committee of the board of directors. On January 1, 2013, 750,000 additional shares were reserved under the ESPP pursuant to the plan's automatic increase provision. As of June 30, 2013, 531,646 shares had been issued under the ESPP and 1,850,400 shares were available for future issuance.

## Note 9 — Income Taxes

The Company files U.S. federal and state and foreign income tax returns in jurisdictions with varying statutes of limitations. In the normal course of business the Company is subject to examination by taxing authorities throughout the world. These audits include questioning the timing and amount of deductions, the allocation of income among various tax jurisdictions and compliance with federal, state, local and foreign tax laws. The Company is currently undergoing examination of the California Franchise Tax Returns relating to California state income taxes of its operating subsidiary for the years 2008 through 2010. The 2008 through 2012 tax years generally remain subject to examination by federal, state and foreign tax authorities. The Company's gross amount of unrecognized tax benefits increased from \$0.4 million as of December 31, 2012 to \$0.6 million as of June 30, 2013, \$55,000 of which, if recognized, would affect the company's effective tax rate. It is difficult to predict the final timing and resolution of any particular uncertain tax position. Based on the Company's assessment of many factors, the Company does not expect that changes in the liability for unrecognized tax benefits for the next twelve months will have a significant impact on the Company's consolidated financial position or results of operations.

During the year ended December 31, 2012 management assessed the realizability of deferred tax assets based on the available evidence, including a history of taxable income and estimates of future taxable income. Management believes that it is not more likely than not that the deferred tax assets will be realized with respect to US federal and state deferred tax assets, except for certain U.S. state deferred tax assets where the Company's subsidiary has profitable operations. Accordingly, a valuation allowance was provided with respect to U.S. federal and most U.S. State deferred tax assets. A valuation allowance was also provided with respect to deferred tax assets from its Singapore and Ireland subsidiaries. The Company will continue to evaluate its ability to realize deferred tax assets on a quarterly basis. Significant management judgment is required in determining the provision for income taxes and deferred tax assets and liabilities. In the event that actual results differ from these estimates the Company will adjust these estimates in future periods and, the Company may need to adjust the effective tax rate for the current year.

The Company considers the undistributed earnings of its foreign subsidiaries permanently reinvested in foreign operations and has not provided for U.S. income taxes on such earnings.

On January 2, 2013, the American Taxpayer Relief Act of 2012 was enacted, which reinstated the federal research tax credit retroactive to January 1, 2012 and extended the credit through December 31, 2013. The 2012 federal research tax credit along with the first six months of 2013 federal research tax credit, which would otherwise have been recognized in the first half of 2013, is fully offset by a valuation allowance.

## Note 10 — Reportable Segments

The Company's operations are principally managed on a geographic basis and are comprised of three reportable and operating segments: NALA, EMEA, and APJ, as defined below.

The Company reports segment information based on the management approach. The management approach designates the internal reporting used by the Company's Chief Operating Decision Maker ("CODM"), for making decisions and assessing

performance as the source of the Company's reportable segments. The CODM is the Company's Chief Executive Officer. The CODM allocates resources to and assesses the performance of each of the operating segment using information about its revenue and direct profit contribution, which is management's measure of segment profitability. Management has determined that the Company's reportable and operating segments are as follows, based on the information used by the CODM:

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NALA — Includes operations from offices in San Francisco, California; Denver, Colorado and Nashville, Tennessee related primarily to end customers in North America.

EMEA — Includes operations from offices in Liverpool, United Kingdom and Dublin, Ireland related primarily to end customers in Europe.

APJ — Includes operations from offices in Singapore related primarily to end customers in Asia Pacific and Japan. Operations in Kuala Lumpur, Malaysia are allocated to the reportable segment of where the customer is located.

The Company does not allocate sales and marketing, research and development, or general and administrative expenses to its geographic regions because management does not include the information in its measurement of the performance of the operating segments. The Company excludes certain items such as stock-based compensation, overhead allocations and other items from direct profit contribution. Revenue for a particular geography reflects fees the Company earns from its customers for sales and renewals of maintenance, support and subscription contracts on their behalf and managed from the Company's sales center in that geography.

Summarized financial information by geographic location based on the Company's internal management reporting and as utilized by the Company's CODM, is as follows (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2013	2012	2013	2012
Net revenue				
NALA	\$42,482	\$36,961	\$80,289	\$73,073
EMEA	18,238	15,518	35,758	31,266
APJ	6,977	7,215	12,771	12,929
Total net revenue	\$67,697	\$59,694	\$128,818	\$117,268
Direct profit contribution				
NALA	\$24,377	\$19,150	\$43,610	\$37,668
EMEA	9,154	7,756	17,879	16,223
APJ	1,909	2,523	2,708	4,106
Total direct profit contribution	35,440	29,429	64,197	57,997
Adjustments:				
Stock-based compensation	(688	) (715	) (1,420	) (1,287
Other, net	(5,675	) (2,902	) (11,077	) (5,900
Gross profit	\$29,077	\$25,812	\$51,700	\$50,810

#### 11. Related Party Transactions

Richard Campione was elected to the Company's Board of Directors (the "Board") on November 29, 2012. On December 19, 2012, the Company entered into a consulting agreement with Mr. Campione under which Mr. Campione provides certain software consulting services to the Company. The Audit Committee of the Board pre-approved this consulting agreement in accordance with the Company's formal policy regarding related party transactions. The Company paid Mr. Campione \$0.3 million for consulting services provided during the term of the agreement, which ended April 30, 2013.

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

The following Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A") should be read in conjunction with our condensed consolidated financial statements and related notes appearing elsewhere in this Quarterly Report on Form 10-Q and with our Annual Report on Form 10-K for the year ended December 31, 2012.

This Quarterly Report on Form 10-Q contains "forward-looking statements" that involve risks and uncertainties, as well as assumptions that, if they never materialize or prove incorrect, could cause our results to differ materially from those expressed or implied by such forward-looking statements. These forward-looking statements include, but are not limited to, statements related to changes in market conditions that impact our ability to generate service revenue on behalf of our customers; errors in estimates as to the service revenue we can generate for our customers; our ability to attract new customers and retain existing customers; risks associated with material defects or errors in our software or the effect of data security breaches; our ability to adapt our solution to changes in the market or new competition; our ability to improve our customers' renewal rates, margins and profitability; our ability to increase our revenue and contribution margin over time from new and existing customers, including as a result of sales of our next-generation technology platform, Renew OnDemand, on a stand-alone subscription basis; our ability to implement Renew OnDemand; the potential effect of mergers and acquisitions on our customer base; business strategies and new sales initiatives; technology development; protection of our intellectual property; investment and financing plans; liquidity; our competitive position; the effects of competition; industry environment; and potential growth opportunities. Forward-looking statements are also often identified by the use of words such as, but not limited to, "anticipate," "believe," "can," "continue," "could," "estimate," "expect," "intend," "may," "plan," "project," "seek," "should," "target," "will" expressions or variations intended to identify forward-looking statements. These statements are based on the beliefs and assumptions of our management based on information currently available to management. Such forward-looking statements are subject to risks, uncertainties and other important factors that could cause actual results and the timing of certain events to differ materially from future results expressed or implied by such forward-looking statements. Factors that could cause or contribute to such differences include, but are not limited to, those identified below, and those discussed in the section of this Quarterly Report on Form 10-Q titled "Risk Factors." Furthermore, such forward-looking statements speak only as of the date of this report. Except as required by law, we undertake no obligation to update any forward-looking statements to reflect events or circumstances after the date of such statements.

All dollar amounts expressed as numbers in this MD&A (except per share amounts) are in millions.

### OVERVIEW

We manage the service contract renewals process for renewals of maintenance, support and subscription agreements on behalf of our customers. Our integrated solution consists of dedicated service sales teams working under our customers' brands and our proprietary Renew OnDemand platform and applications. By integrating software, managed services and data, we address the critical steps of the renewals process including data management, quoting, selling and service revenue business intelligence. Our business is built on our pay-for-performance model, whereby our revenues are based on the service renewals customers achieve with our solution, although we have been establishing a base of subscription revenue agreements to our technology platform and applications.

We are currently in the midst of a significant investment cycle in which we have taken steps designed to drive our future growth and profitability. We plan to further build out our infrastructure, develop our technology and support Renew OnDemand, our next-generation technology platform, offer additional cloud-based applications, including on a stand-alone, subscription basis, and hire additional sales, service sales and other personnel. These steps impacted our expenses in recent periods as well as our spending for capital expenditures, and are expected to continue to impact our profitability and cash flows in future periods. We have devoted significant resources to developing Renew OnDemand, our software application suite which was recently introduced, and we expect our investment in Renew OnDemand to continue. In addition, we plan to devote significant resources to expand our sales organization, build out the related partner ecosystem, and further develop our service organization to support the platform. We also plan on making targeted brand investments like in industry events like Dreamforce, as well as re-launching our website and producing new marketing collateral. On the sales side, we have seen early success with some of the new sales

incentives around Renew OnDemand subscriptions, which drives short-term expense, but has improved our time to market this new solution. The capital expenditures and expenses related to Renew OnDemand are in addition to the expenses of operating our existing technology platform. While these expenses will be incurred and recognized in the near-term, we expect to generate revenues from the sale of subscriptions to Renew OnDemand that will increase over time in 2013

#### Key Business Metrics

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In assessing the performance of our business, we consider a variety of business metrics in addition to the financial metrics discussed below under, “Basis of Presentation.” These key metrics include service revenue opportunity under management and number of engagements.

**Service Revenue Opportunity Under Management.** At June 30, 2013, we estimate our opportunity under management to be over \$9 billion. Service revenue opportunity under management (“opportunity under management”) is a forward-looking metric and is our estimate, as of a given date, of the value of all end customer service contracts that we will have the opportunity to sell on behalf of our customers over the subsequent twelve-month period. Opportunity under management is not a measure of our expected revenue. In addition, opportunity under management reflects our estimate for a forward twelve-month period and should not be used to estimate our opportunity for any particular quarter within that period. The value of end customer contracts actually delivered during a twelve-month period should not be expected to occur in even quarterly increments due to seasonality and other factors impacting our customers and their end customers.

We estimate the value of such end customer contracts based on a combination of factors, including the value of end customer contracts made available to us by customers in past periods, the minimum value of end customer contracts that our customers are required to give us the opportunity to sell pursuant to the terms of their contracts with us, periodic internal business reviews of our expectations as to the value of end customer contracts that will be made available to us by customers, the value of end customer contracts included in the SPA and collaborative discussions with our customers assessing their expectations as to the value of service contracts that they will make available to us for sale. While the minimum value of end customer contracts that our customers are required to give us represents a portion of our estimated opportunity under management, a significant portion of the opportunity under management is estimated based on the other factors described above. As our experience with our business, our customers and their contracts has grown, we have continually refined the process, improved the assumptions and expanded the data related to our calculation of opportunity under management.

When estimating service revenue opportunity under management, we must, to a large degree, rely on the assumptions described above, which may prove incorrect. These assumptions are inherently subject to significant business and economic uncertainties and contingencies, many of which are beyond our control. Our estimates therefore may prove inaccurate, causing the actual value of end customer contracts delivered to us in a given twelve-month period to differ from our estimate of opportunity under management. These factors include:

- the extent to which customers deliver a greater or lesser value of end customer contracts than may be required or otherwise expected;
- roll-overs of unsold service contract renewals from prior periods to the current period or future periods;
- changes in the pricing or terms of service contracts offered by our customers;
- increases or decreases in the end customer base of our customers;
- the extent to which the renewal rates we achieve on behalf of a customer early in an engagement affect the amount of opportunity that the customer makes available to us later in the engagement;
- customer cancellations of their contracts with us; and
- changes in our customers’ businesses, sales organizations, management, sales processes or priorities.

Our revenue also depends on our close and commissions rates. Our close rate is the percentage of opportunity under management that we renew on behalf of our customers. Our commission rate is an agreed-upon percentage of the renewal value of end customer contracts that we sell on behalf of our customers.

Our close rate is impacted principally by our ability to successfully sell service contracts on behalf of our customers. Other factors impacting our close rate include: the manner in which our customers price their service contracts for sale to their end customers; the stage of life-cycle associated with the products and underlying technologies covered by the

service contracts offered to the end customer; the extent to which our customers or their competitors introduce new products or underlying technologies; the nature, size and age of the service contracts; and the extent to which we have managed the renewals process for similar products and underlying technologies in the past.

In determining commission rates for an individual engagement, various factors, including our close rates, as described above, are evaluated. These factors include: historic, industry-specific and customer-specific renewal rates for similar service contracts; the magnitude of the opportunity under management in a particular engagement; the number of end customers associated with these opportunities; and the opportunity to receive additional performance commissions when we exceed certain renewal levels. We endeavor to set our commission rates at levels commensurate with these factors and other factors that may be relevant to a particular engagement.

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Accordingly, our commission rates vary, often significantly, from engagement to engagement. In addition, we sometimes agree to lower commission rates for engagements with significant opportunity under management.

**Number of Engagements.** We track the number of engagements we have with our customers. We often have multiple engagements with a single customer, particularly where we manage the sales of service renewals relating to different product lines, technologies, types of contracts or geographies for the customer. When the set of renewals we manage on behalf of a customer is associated with a separate customer contract or a distinct product set, type of end customer contract or geography and therefore requires us to assign a service sales team to manage the differentiated renewals, we designate each set of renewals, and associated revenues and costs to us as a unique engagement. For example, we may have one engagement consisting of a service sales team selling maintenance contract renewals of a particular product for a customer in the United States and another engagement consisting of a sales team selling warranty contract renewals of a different product for the same customer in Europe. These would count as two engagements. We had approximately 145, 120 and 100 engagements as of December 31, 2012, 2011 and 2010, respectively.

### **Factors Affecting our Performance**

**Sales Cycle.** We sell our integrated solution through our sales organization. At the beginning of the sales process, our quota-carrying sales representatives contact prospective customers and educate them about our offerings. Educating prospective customers about the benefits of our solution can take time, as many of these prospects have not historically relied upon integrated solutions like ours for service revenue management, nor have they typically put out a formal request for proposal or otherwise made a decision to focus on this area. As part of our sales process, we utilize our solutions design team to perform a

Service Performance Analysis (“SPA”) of our prospect’s service revenue. The SPA includes an analysis of best practices and benchmarks the prospect’s service revenue against industry peers. Through the SPA process, which typically takes several weeks, we are able to assess the characteristics and size of the prospect’s service revenue, identify potential areas of performance improvement, and formulate our proposal for managing the prospect’s service revenue. The length of our sales cycle for a new customer, inclusive of the SPA process and measured from our first formal discussion with the customer until execution of a new customer contract, is typically longer than six months and has increased in recent periods.

We generally contract with new customers to manage a specified portion of their service revenue opportunity, such as the opportunity associated with a particular product line or technology, contract type or geography. We negotiate the engagement-specific terms of our customer contracts, including commission rates, based on the output of the SPA, including the areas identified for improvement. Once we demonstrate success to a customer with respect to the opportunity under contract, we seek to expand the scope of our engagement to include other opportunities with the customer. For some customers, we manage all or substantially all of their service contract renewals.

**Implementation Cycle.** After entering into an engagement with a new customer, and to a lesser extent after adding an engagement with an existing customer, we incur sales and marketing expenses related to the commissions owed to our sales personnel. The commissions are based on the estimated total contract value, with a material portion of the commission expensed upfront with the remaining portion expensed over a period of eight to fourteen months. We also make upfront investments in technology and personnel to support the engagement. These expenses are typically incurred one to three months before we begin generating sales and recognizing revenue. Accordingly, in a given quarter, an increase in new customers, and, to a lesser extent, an increase in engagements with existing customers, or a significant increase in the contract value associated with such new customers and engagements, will negatively impact our gross margin and operating margins until we begin to achieve anticipated sales levels associated with the new engagements, which is typically two-to-three quarters after we begin selling contracts on behalf of our customers. Although we expect new customer engagements to contribute to our operating profitability over time, in the initial periods of a customer relationship, the near term impact on our profitability can be negatively impacted by slower-than anticipated growth in revenues for these engagements as well as the impact of the upfront costs we incur, the lower initial level of associated service sales team productivity and lack of mature data and technology integration with the customer. As a result, an increase in the mix of new customers as a percentage of total customers may initially have a negative impact on our operating results. Similarly, a decline in the ratio of new customers to total

customers may positively impact our operating results.

**Contract Terms.** Substantially all of our revenue comes from our pay-for-performance model. Under our pay-for-performance model, we earn commissions based on the value of service contracts we sell on behalf of our customers. In some cases, we earn additional performance-based commissions for exceeding pre-determined service renewal targets.

Since 2009, our new customer contracts have typically had a term of approximately 36 months, although we sometimes have contract terms of up to 60 months. Our contracts generally require our customers to deliver a minimum value of

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qualifying service revenue contracts for us to renew on their behalf during a specified period. To the extent that our customers do not meet their minimum contractual commitments over a specified period, they may be subject to fees for the shortfall. Our customer contracts are cancelable on relatively short notice, subject in most cases to the payment of an early termination fee by the customer. The amount of this fee is based on the length of the remaining term and value of the contract.

We invoice our customers on a monthly basis based on commissions we earn during the prior month, and with respect to performance-based commissions, on a quarterly basis based on our overall performance during the prior quarter. Amounts invoiced to our customers are recognized as revenue in the period in which our services are performed or, in the case of performance commissions, when the performance condition is determinable. Because the invoicing for our services generally coincides with or immediately follows the sale of service contracts on behalf of our customers, we do not generate or report a significant deferred revenue balance. However, the combination of minimum contractual commitments, our success in generating improved renewal rates for our customers, our customers' historical renewal rates and the performance improvement potential identified by our SPA process, provides us with revenue visibility. M&A Activity. Our customers, particularly those in the technology sector, participate in an active environment for mergers and acquisitions. Large technology companies have maintained active acquisition programs to increase the breadth and depth of their product and service offerings and small and mid-sized companies have combined to better compete with large technology companies. A number of our customers have merged, purchased other companies or been acquired by other companies. We expect merger and acquisition activity to continue to occur in the future. The impact of these transactions on our business can vary. Acquisitions of other companies by our customers can provide us with the opportunity to pursue additional business to the extent the acquired company is not already one of our customers.

Similarly, when a customer is acquired, we may be able to use our relationship with the acquired company to build a relationship with the acquirer. In some cases we have been able to maintain our relationship with an acquired customer even where the acquiring company handles its other service contract renewals through internal resources. In other cases, however, acquirers have elected to terminate or not renew our contract with the acquired company. For example, Oracle terminated our contracts with Sun Microsystems effective as of September 30, 2010 and had previously terminated our contract with another customer, BEA Systems, in April 2008.

Economic Conditions and Seasonality. An improving economic outlook generally has a positive, but mixed, impact on our business. As with most businesses, improved economic conditions can lead to increased end customer demand and sales. In particular, within the technology sector, we believe that the recent economic downturn led many companies to cut their expenses by choosing to let their existing maintenance, support and subscription agreements lapse. An improving economy may have the opposite effect.

However, an improving economy may also cause companies to purchase new hardware, software and other technology products, which we generally do not sell on behalf of our customers, instead of purchasing maintenance, support and subscription services for existing products. To the extent this occurs, it would have a negative impact on our opportunities in the near term that would partially offset the benefits of an improving economy.

We believe the current uncertainty in the economy, combined with shifting market forces toward subscription-based models, is impacting a number of our customers and prospective customers, particularly in the traditional enterprise software and hardware segments. These forces have placed pressure on end customer demand for their renewal contracts and also have led to some slower decision making in general. This economic and industry environment has adversely affected the conversion rates for end customers and contracts. To the extent these conditions continue they will impact our future revenues.

In addition to the uncertainty in the macroeconomic environment, we experience a seasonal variance in our revenue typically for the third quarter of the year as a result of lower or flat renewal volume corresponding to the timing of our customers' product sales particularly in the international regions. The impact of this seasonal fluctuation can be amplified if the economy as a whole is experiencing disruption or uncertainty, leading to deferral of some renewal decisions. As we increase our subscription revenue base, this seasonality will become less apparent. However for at least the next couple years, we would expect this pattern to continue.

Adoption of “Software-as-a-Service” Solutions. Within the software industry, there is a growing trend toward providing software to customers using a software-as-a-service (“SaaS”) model. Under this model, SaaS companies provide access to software applications to customers on a remote basis, and provide their customers with a subscription to use the software, rather than licensing software to their customers. SaaS companies face a distinct set of challenges with respect to customer renewals, given the potentially lower switching costs for customers utilizing their solutions, and are more reliant on renewals for their long-term revenues than traditional software companies. Given the strategic importance of renewals to their model, SaaS companies may be less inclined than traditional software companies to rely on third-party solutions such as ours to manage the sale of renewals of subscription contracts. We have tailored our solution to address the needs of SaaS companies in this area

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and expect to continue to develop and enhance our solution as this market grows, especially with our Renew OnDemand application suite.

In connection with our purpose-built SaaS offering to manage and maximize recurring revenue, we intend to significantly increase our investment in our customer support, training and professional services organizations to support deployments of Renew OnDemand. We anticipate that the cost of providing professional services, support and training will be significant and that our gross profit will be adversely affected as we build out these functions.

### Basis of Presentation

#### Net Revenue

Substantially all of our net revenue is attributable to commissions we earn from the sale of renewals of maintenance, support and subscription agreements on behalf of our customers. We generally invoice our customers for our services in arrears on a monthly basis for sales commissions, and on a quarterly basis for certain performance sales commissions; accordingly, we typically have no deferred revenue related to these services. We do not set the price, terms or scope of services in the service contracts with end customers and do not have any obligations related to the underlying service contracts between our customers and their end customers.

We also earn revenue from the sale of subscriptions to our cloud based applications. To date, subscription revenue has been insignificant, but we expect revenues generated from subscriptions to Renew OnDemand to increase in 2013. Subscription fees are accounted for separately from commissions, and they are billed in advance over a monthly, quarterly or annual basis. Subscription revenue is recognized ratably over the related subscription term.

We have generated a significant portion of our revenue from a limited number of customers. Our top ten customers accounted for 51% and 49% of our net revenue for the three months ended June 30, 2013 and 2012, respectively, and 49% and 49% for the six months ended June 30, 2013 and 2012, respectively.

Our business is geographically diversified. During the second quarter of 2013, 63% of our net revenue was earned in North America and Latin America (“NALA”), 27% in Europe, Middle East and Africa (“EMEA”) and 10% in Asia Pacific-Japan (“APJ”). Net revenue for a particular geography generally reflects commissions earned from sales of service contracts managed from our sales centers in that geography. Predominantly all of the service contracts sold and managed by our sales centers relate to end customers located in the same geography.

#### Cost of Revenue and Gross Profit

Our cost of revenue expenses include compensation, technology costs, including those related to the delivery of our cloud-based solutions, and allocated overhead costs. Compensation includes salary, bonus, benefits and stock-based compensation for our dedicated service sales teams. Our allocated overhead includes costs for facilities, information technology and depreciation, including amortization of internal-use software associated with our service revenue technology platform and cloud applications. Allocated costs for facilities consist of rent, maintenance and compensation of personnel in our facilities departments. Our allocated costs for information technology include costs associated with third-party data centers where we maintain our data servers, compensation of our information technology personnel and the cost of support and maintenance contracts associated with computer hardware and software. To the extent our customer base or opportunity under management expands, we may need to hire additional service sales personnel and invest in infrastructure to support such growth. We currently expect that our cost of revenue will fluctuate significantly and may increase on an absolute basis and as a percentage of revenue in the near term, including for the reasons discussed above under, “—Factors Affecting Our Performance—Implementation Cycle” and as a result of our near term plans to run dual technology platforms for several quarters as we commence the launch of Renew OnDemand while maintaining our existing technology platform.

#### Operating Expenses

**Sales and Marketing.** Sales and marketing expenses are the largest component of our operating expenses and consist primarily of compensation and sales commissions for our sales and marketing staff, allocated expenses and marketing programs and events. We sell our solutions through our global sales organization, which is organized across three geographic regions: NALA, EMEA and APJ. Our commission plans provide that payment of commissions to our sales representatives is contingent on their continued employment, and we recognize expense over a period that is generally between twelve and fourteen months following the execution of the applicable contract. We currently expect sales and

marketing expenses to increase on an absolute basis and as a percentage of revenue in the near term based on commissions earned on customer contracts entered into in prior periods, as well as continued investments in sales and marketing personnel and programs as we expand our business domestically and internationally and pursue new sales initiatives.

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**Research and Development.** Research and development expenses consist primarily of compensation, allocated costs and the cost of third-party service providers. We focus our research and development efforts on developing new products, including Renew OnDemand, our next-generation technology platform, and adding new features to our existing technology platform. In connection with the development and enhancements of our SaaS applications, we capitalize certain expenditures related to the development and enhancement of internal-use software related to our technology platform. We expect research and development spending to increase on an absolute basis and as a percentage of revenue in the near term as we continue to invest in our Renew OnDemand platform and our expectation that future capitalization of internal-use software costs will be insignificant.

**General and Administrative.** General and administrative expenses consist primarily of compensation for our executive, human resources, finance and legal functions, and related expenses for professional fees for accounting, tax and legal services, as well as allocated expenses. We expect that our general and administrative expenses will increase on an absolute basis to support our anticipated growth.

**Other Income (Expense)**

Other income (expense) consists primarily of interest expense associated with fees related to our credit facility, foreign exchange transaction gains and losses and interest income.

**Income Tax (Benefit) Provision**

We account for income taxes using an asset and liability method, which requires the recognition of taxes payable or refundable for the current year and deferred tax assets and liabilities for the expected future tax consequences of temporary differences that currently exist between the tax basis and the financial reporting basis of our taxable subsidiaries' assets and liabilities using the enacted tax rates in effect for the year in which the differences are expected to reverse. The effect of a change in tax rates on deferred tax assets and liabilities is recognized in operations in the period that includes the enactment date. The measurement of deferred tax assets is reduced, if necessary, by the amount of any tax benefits that, based on available evidence, are not expected to be realized.

We account for unrecognized tax benefits using a more-likely-than-not threshold for financial statement recognition and measurement of tax positions taken or expected to be taken in a tax return. We establish reserves for tax-related uncertainties based on estimates of whether, and the extent to which, additional taxes will be due. We record an income tax liability, if any, for the difference between the benefit recognized and measured and the tax position taken or expected to be taken on our tax returns. To the extent that the assessment of such tax positions change, the change in estimate is recorded in the period in which the determination is made. The reserves are adjusted in light of changing facts and circumstances, such as the outcome of a tax audit. The provision for income taxes includes the impact of reserve provisions and changes to reserves that are considered appropriate.

**Results of Operations**

The table below sets forth our consolidated results of operations for the periods presented. The period-to-period comparison of financial results presented below is not necessarily indicative of financial results to be achieved in future periods.

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	Three Months Ended		Six Months Ended	
	June 30, 2013 (in thousands)	2012	June 30, 2013 (in thousands)	2012
Net revenue	\$67,697	\$59,694	\$128,818	\$117,268
Cost of revenue	38,620	33,882	77,118	66,458
Gross profit	29,077	25,812	51,700	50,810
Operating expenses:				
Sales and marketing	15,367	14,169	30,175	27,646
Research and development	6,794	4,298	13,042	8,879
General and administrative	10,783	10,564	22,004	20,639
Total operating expenses	32,944	29,031	65,221	57,164
Loss from operations	(3,867	) (3,219	) (13,521	) (6,354
Other expense, net	(295	) (333	) (403	) (424
Loss before income taxes	(4,162	) (3,552	) (13,924	) (6,778
Income tax provision	744	33,217	1,437	31,267
Net loss	\$(4,906	) \$(36,769	) \$(15,361	) \$(38,045
Includes stock-based compensation of:				
Cost of revenue	\$688	\$715	\$1,420	\$1,287
Sales and marketing	2,449	1,982	4,982	3,656