SERVICESOURCE INTERNATIONAL, INC.
Form 10-Q
May 10, 2013
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended March 31, 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 Incorporation or Organization)	**(I.R.S. Employer Identification No.)**
634 Second Street San Francisco, California	**94107**
(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 x 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 x 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	x
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 x

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 April 30, 2013**
Common Stock	76,823,424

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PART I FINANCIAL INFORMATION

Item 1. ***Financial Statements***

SERVICESOURCE INTERNATIONAL, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS

(In thousands)

(Unaudited)

	March 31, 2013	December 31, 2012
Assets		
Current assets:		
Cash and cash equivalents	$ 67,947	$ 76,568
Short-term investments	49,755	32,874
Accounts receivable, net	59,039	65,238
Current portion of deferred income taxes	177	389
Prepaid expenses and other	5,089	5,178
Total current assets	182,007	180,247
Property and equipment, net	32,342	34,513
Deferred income taxes, net of current portion	2,069	2,321
Other assets, net	735	1,057
Goodwill	6,334	6,334
Total assets	$ 223,487	$ 224,472
Liabilities and Stockholders Equity		
Current liabilities:		
Accounts payable	$ 5,319	$ 3,293
Accrued taxes	269	1,056
Accrued compensation and benefits	14,677	15,738
Accrued liabilities and other	11,074	10,403
Obligations under capital leases	325	326
Total current liabilities	31,664	30,816
Obligations under capital leases, net of current portion	543	638
Other long-term liabilities	5,005	6,091
Total liabilities	37,212	37,545
Commitments and contingencies (Note 7)		
Stockholders equity:		
Common stock; $0.0001 par value; 1,000,000 shares authorized; 76,840 shares issued and 76,719 shares outstanding as of March 31, 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	220,357	210,650
Accumulated deficit	(33,853)	(23,398)

Accumulated other comprehensive income	204	108
Total stockholders equity	186,275	186,927
Total liabilities and stockholders equity	$ 223,487	$ 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 March 31,	
	2013	**2012**
Net revenue	$ 61,121	$ 57,574
Cost of revenue	38,498	32,576
Gross profit	22,623	24,998
Operating expenses:		
Sales and marketing	14,808	13,477
Research and development	6,248	4,581
General and administrative	11,222	10,075
Total operating expenses	32,278	28,133
Loss from operations	(9,655)	(3,135)
Other expense, net	(107)	(91)
Loss before income taxes	(9,762)	(3,226)
Income tax provision (benefit)	693	(1,950)
Net loss	$ (10,455)	$ (1,276)
Net loss per common share:		
Basic	$ (0.14)	$ (0.02)
Diluted	(0.14)	(0.02)
Weighted-average shares used in computing net loss per common share:		
Basic	75,610	73,212
Diluted	75,610	73,212

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

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SERVICESOURCE INTERNATIONAL, INC.

CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)

(In thousands)

(Unaudited)

	Three Months Ended March 31,	
	2013	2012
Net loss	$ (10,455)	$ (1,276)
Other comprehensive income, net of tax:		
Foreign currency translation adjustments	65	(17)
Unrealized gain on short-term investments, net of tax	31	40
Other comprehensive income, net of tax	96	23
Total comprehensive loss, net of tax	$ (10,359)	$ (1,253)

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)

	Three Months Ended March 31, 2013	Three Months Ended March 31, 2012
Cash flows from operating activities		
Net loss	$ (10,455)	$ (1,276)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:		
Depreciation and amortization	3,206	2,268
Loss on disposal of fixed assets	29	28
Provision for doubtful accounts	(67)	
Amortization of deferred financing costs	12	27
Accretion on premium on short-term investments	174	154
Deferred income taxes	461	(873)
Stock-based compensation	5,921	4,247
Income tax charge from stock-based compensation	181	362
Changes in operating assets and liabilities:		
Accounts receivable	5,863	(5,084)
Prepaid expenses and other	415	(2,407)
Accounts payable	2,077	(1,257)
Accrued taxes	(779)	490
Accrued compensation and benefits	(890)	(6,783)
Other accrued liabilities	(268)	3,780
Net cash provided by (used in) operating activities	5,880	(6,324)
Cash flows from investing activities		
Acquisition of property and equipment	(1,232)	(6,631)
Purchases of short-term investments	(18,034)	(8,390)
Sales of short-term investments	508	1,430
Maturities of short-term investments	500	4,890
Net cash used in investing activities	(18,258)	(8,701)
Cash flows from financing activities		
Repayment on capital leases obligations	(80)	(80)
Proceeds from common stock issuances	3,741	5,821
Income tax charge from stock-based compensation	(181)	(362)
Net cash provided by financing activities	3,480	5,379
Net decrease in cash and cash equivalents	(8,898)	(9,646)
Effect of exchange rate changes on cash and cash equivalents	277	(232)
Cash and cash equivalents at beginning of period	76,568	65,983
Cash and cash equivalents at end of period	$ 67,947	$ 56,105

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

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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. 2013-02 Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income. ASU No. 2013-02 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 significant.

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 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 months ended March 31, 2013 and 2012 were insignificant.

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Cash and cash equivalents and short-term investments consisted of the following as of March 31, 2013 and December 31, 2012 (in thousands):

March 31, 2013

	Amortized Cost	Unrealized Gains	Unrealized Losses	Estimated Fair Value
Cash	$ 67,834	$	$	$ 67,834
Cash equivalents:				
Money market mutual funds	113			113
Total cash and cash equivalents	67,947			67,947
Short-term investments:				
Corporate bonds	19,652	19	(7)	19,664
U.S. agency securities	20,283	11	(3)	20,291
Asset-backed securities	5,231	1	(5)	5,227
U.S. Treasury securities	4,569	4		4,573
Total short-term investments	49,735	35	(15)	49,755
Cash, cash equivalents and short-term investments	$ 117,682	$ 35	$ (15)	$ 117,702

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	$ 109,452	$ 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 March 31, 2013:

	Amortized Cost	Estimated Fair Value
Less than 1 year	$ 3,169	$ 3,169
Due in 1 to 3 years	46,566	46,586
Total	$ 49,735	$ 49,755

As of March 31, 2013, the Company did not consider any of its investments to be other-than-temporarily impaired.

Note 3 Fair value of financial instruments

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.

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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 March 31, 2013 and indicates the fair value hierarchy of the valuation (in thousands):

	Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Description				
Cash equivalents:				
Money market mutual funds	$ 113	$ 113	$	$
Total cash equivalents	113	113		
Short-term investments:				
Corporate bonds	19,664		19,664	
U.S. agency securities	20,291		20,291	
Asset-backed securities	5,227		5,227	
U.S. Treasury securities	4,573		4,573	
Total short-term investments	49,755		49,755	
Cash equivalents and short-term investments	$ 49,868	$ 113	$ 49,755	$

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):

	Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Description				
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	
Total short-term investments	32,874		32,874	
Cash equivalents and short-term investments	$ 49,874	$ 17,000	$ 32,874	$

The Company did not have any financial liabilities measured at fair value on a recurring basis as of March 31, 2013 or December 31, 2012.

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Note 4 Property and Equipment, Net

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

	March 31, 2013	December 31, 2012
Computers and equipment	$ 15,136	$ 14,733
Software	33,095	32,982
Furniture and fixtures	8,682	8,555
Leasehold improvements	10,973	10,801
	67,886	67,071
Less: accumulated depreciation and amortization	(35,602)	(32,558)
	32,284	34,513
Construction in progress	58	
	$ 32,342	$ 34,513

Depreciation and amortization expense related to property and equipment was $3.2 million and $2.3 million during the three months ended March 31, 2013 and 2012 respectively.

Total property and equipment assets under capital lease at March 31, 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 $2.2 million and $2.1 million, respectively.

The Company capitalized internal-use software development costs of $0 and $2.2 million during the three months ended March 31, 2013 and 2012, respectively. As of March 31, 2013 and December 31, 2012, the carrying value of capitalized costs related to internal-use software, net of accumulated amortization, was $12.4 million and $13.6 million, respectively. Amortization of capitalized costs related to internal-use software for the three months ended March 31, 2013 and 2012 was $1.3 million and $0.6 million, respectively.

Note 5 Accrued Liabilities and Other

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

	March 31, 2013	December 31, 2012
Deferred revenue	$ 4,196	$ 2,295
Accrued operating expenses	2,652	3,664
Deferred rent obligations	898	986
Other employee related	305	323
Accrued other (includes ESPP contributions of $296 and $1,059 at March 31, 2013 and December 31, 2012, respectively)	3,023	3,135
	$ 11,074	$ 10,403

Note 6 Credit Facility and Capital Leases

Revolving Credit Facility

On July 5, 2012, the Company, entered into a new 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. Proceeds available under the agreement may be used for working capital and other general corporate purposes. The Company may prepay borrowing under 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.

Amounts outstanding on the facility at March 31, 2013 consisted of a letter of credit of $850,000 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 0.45%. At March 31, 2013, the interest rate for borrowings under the facility would be 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 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 2.51% and 3.62 % at March 31, 2013 and 2012, respectively.

Future minimum annual payments under capital lease obligations as of March 31, 2013 were as follows (in thousands):

	March 31, 2013
Years Ending December 31,	
2013 (remaining nine months)	$ 243
2014	265
2015	72
2016	74
2017	76
Thereafter	138
	$ 868

Note 7 Commitments and Contingencies

Operating 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 March 31, 2013 and 2012 was $2.2 million and $2.3 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.

Future annual minimum lease payments under all noncancelable operating leases as of March 31, 2013 were as follows (in thousands):

	March 31, 2013

Years Ending December 31,	
2013 (remaining nine months).	$ 5,964
2014	7,032
2015	5,334
2016	3,956
2017	4,000
Thereafter	12,525
	$ 38,811

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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 maintained 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.

On February 8, 2012, the Company issued 200,000 performance-based equity awards to an executive which vest upon the achievement of certain financial performance goals, including revenue and an internal metric that is used for measuring customer contract commitments based on a net recurring revenue amount in which the Company measures customer revenue gains offset by losses during the measurement period. Determining the appropriate amount to expense based on the anticipated achievement of the stated goals requires judgment, including forecasting future financial results. The estimate of the timing of the expense recognition is revised periodically based on the probability of achieving the required performance targets and adjustments are made as appropriate. The cumulative impact of any revision is reflected in the period of the change. If the financial performance goals are not met, the award does not vest, no compensation cost is recognized and any previously stock-recognized stock-based compensation expense is reversed. No expense was recorded for the performance based equity award during the three months ended March 31, 2013.

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.

Stock Option Exchange Program

On December 21, 2012, the Company launched a stock option exchange program (the Offer) pursuant to which eligible employees were able to exchange certain outstanding out-of-the money stock options with an exercise price greater than $6.03 per share for a lesser amount of new stock options. The Offer expired on January 22, 2013. As a result of the Offer, options to purchase an aggregate of 2.8 million shares of the Company s common stock were accepted for exchange (representing approximately 80% of the total options eligible for exchange). All surrendered options were cancelled effective as of the expiration of the Offer, and in exchange for those options, the Company issued a total of approximately 1.0 million new stock options. The exercise price per share of each new option granted pursuant to the Offer was $6.03 per share, the closing price of

the Company s common stock on January 22, 2013. The new stock options have the same vesting schedules as the options tendered for exchange. In addition the new options are not exercisable for a one-year period from the Offer s expiration date. The Offer did not result in any significant incremental stock-based compensation expense

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 months ended March 31, 2013 and 2012 were as follows:

	Three Months Ended March 31, 2013	2012
Expected term (in years)	5.0	5.1
Expected volatility	44%	45%
Risk-free interest rate	0.89%	0.82%
Expected dividend yield		

Option and restricted stock activity under the 2011 Plan for the three months ended March 31, 2013 were as follows (shares in thousands)

	Shares and Units Available for Grant	Options Outstanding: Number of Shares	Options Outstanding: 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	(2,663)	1,292	6.39	1,371
Options exercised/ Restricted stock released		(685)	4.24	(215)
Canceled/Forfeited	3,967	(3,545)	13.82	(422)
Outstanding March 31, 2013	8,353	12,251	5.08	4,662

The weighted average grant-date fair value of employee stock options granted was $2.70 and $7.04 during the three months ended March 31, 2013 and 2012, respectively.

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

	March 31, 2013	2012
Cost of revenue	$ 732	$ 572
Sales and marketing	2,534	1,674
Research and development	486	363

General and administrative	2,169	1,638
Total stock-based compensation	$ 5,921	$ 4,247

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:

	Three Months Ended March 31, 2013	Three Months Ended March 31, 2012
Expected term (in years)	0.50	0.50
Expected volatility	27%	45%
Risk-free interest rate	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 automatic increase. As of March 31, 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 not currently undergoing any examination of its income tax returns. 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 March 31, 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, 2102 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, Ireland and Japan 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 its 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 research tax credit retroactive to January 1, 2012 and extended the credit through December 31, 2013. This tax benefit, which would otherwise be recognized this quarter, 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

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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:

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 Kuala Lumpur, Malaysia and Singapore related primarily to end customers in Asia Pacific and Japan.

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 March 31, 2013	2012
Net revenue		
NALA	$ 37,807	$ 36,112
EMEA	17,520	15,748
APJ	5,794	5,714
Total net revenue	$ 61,121	$ 57,574
Direct profit contribution		
NALA	$ 19,233	$ 18,515
EMEA	8,725	8,467
APJ	799	1,583
Total direct profit contribution	28,757	28,565
Adjustments:		
Stock-based compensation	(732)	(572)
Overhead allocations	(6,572)	(5,344)
Other, net	1,170	2,349
Gross profit	$ 22,623	$ 24,998

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. Total payments in the three months ended March 31, 2013 to Mr. Campione totaled $0.2 million. 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, would, and similar 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 a suite of cloud applications, 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.

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. 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 subscriptions of Renew OnDemand that will increase over time in 2013.

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

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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 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.

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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

Certain new engagements we entered into during the second half of 2012 have not yet fully ramped-up to performance levels we anticipate achieving over time. As a result, our revenues have not reflected, and are not expected in the first half of 2013 to reflect, the full revenue and operating margin potential from these customers. 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. 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.

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 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. For the three months ended March 31, 2013 and 2012, our top ten customers in each period accounted for 49% and 51% of our net revenue, respectively.

Our business is geographically diversified. During the first quarter of 2013, 62% of our net revenue was earned in North America and Latin America (NALA), 29% in Europe, Middle East and Africa (EMEA) and 9% 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.

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.

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Other Income (Expense)

Other income (expense) consists primarily of interest expense associated with borrowings under 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.

	Three Months Ended March 31,	
	2013	2012
	(in thousands)	
Net revenue	$ 61,121	$ 57,574
Cost of revenue	38,498	32,576
Gross profit	22,623	24,998
Operating expenses:		
Sales and marketing	14,808	13,477
Research and development	6,248	4,581
General and administrative	11,222	10,075
Total operating expenses	32,278	28,133
Loss from operations	(9,655)	(3,135)
Other expense, net	(107)	(91)
Loss before income taxes	(9,762)	(3,226)
Income tax provision (benefit)	693	(1,950)
Net loss	$ (10,455)	$ (1,276)
Includes stock-based compensation of:		
Cost of revenue	$ 732	$ 572

Sales and marketing	2,534	1,674
Research and development	486	363
General and administrative	2,169	1,638
Total stock-based compensation	$ 5,921	$ 4,247

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The following table sets forth our operating results as a percentage of net revenue:

	Three Months Ended March 31,	
	2013	2012
	(as % of net revenue)	
Net revenue	100%	100%
Cost of revenue	63%	57%
Gross profit	37%	43%
Operating expenses:		
Sales and marketing	24%	23%
Research and development	10%	8%
General and administrative	18%	17%
Total operating expenses	52%	48%
Loss from operations	(15)%	(5)%

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Net Revenue

	Three Months Ended March 31, 2013 Amount	2013 % of Net Revenue	2012 Amount	2012 % of Net Revenue	Change	% Change
			(in thousands)			
Net revenue by geography:						
NALA	$ 37,807	62%	$ 36,112	63%	$ 1,695	5%
EMEA	17,520	29%	15,748	27%	1,772	11%
APJ	5,794	9%	5,714	10%	79	1%
Total net revenue	$ 61,121	100%	$ 57,574	100%	$ 3,547	6%

Net revenue increased $3.5 million, or 6%, for the first quarter of 2013, compared to the first quarter of 2012. Our revenue performance was driven by a combination of growth in opportunity from new and existing customers, as well as strong performance across all of our service sales centers around the world in closing service revenue renewals. The increase in our customer engagements resulted from new engagements with certain existing customers as well as new customer acquisitions due to our investments in our sales organization. These increases were partially offset by some customers in all three geographies where the scope of our services was reduced.

Cost of Revenue and Gross Profit

	Three Months Ended March 31, 2013	2012	Change	% Change
		(in thousands)		
Cost of revenue	$ 38,498	$ 32,576	$ 5,922	18%
Includes stock-based compensation of:	732	572	160	
Gross profit	22,623	24,998	(2,375)	(10)%
Gross profit percentage	37%	43%		(6)%

The 18% increase in our cost of revenue in the first quarter of 2013 reflected a $4.5 million increase in an increase in compensation, attributable in part to an increase in the number of sales enablement personnel in our global sales operations center in Kuala Lumpur, Malaysia associated with two large expansions with existing customers, as well as a $1.2 million increase in technology and amortization expense of our internally developed software. Gross profit in the first quarter of 2013 was also adversely impacted by the slower ramp of some of our larger new engagements and due to staffing and technology costs associated with the deployment of our cloud applications. For the next several quarters, we expect that we will have increased spending to continue support for our legacy service revenue intelligence platform in addition to growing support expenditures for our Renew OnDemand application suite.

Operating Expenses

	Three Months Ended March 31, 2013 Amount	2013 % of Net Revenue	2012 Amount	2012 % of Net Revenue	Change	% Change
			(in thousands)			
Operating expenses:						
Sales and marketing	$ 14,808	24%	$ 13,477	23%	$ 1,331	10%
Research and development	6,248	20%	4,581	8%	1,667	36%
General and administrative	11,222	18%	10,075	17%	1,147	11%

Total operating expenses	$ 32,278	52%	$ 28,133	48%	$ 4,145	15%
Includes stock-based compensation of:						
Sales and marketing	$ 2,534		$ 1,674		$ 860	
Research and development	486		363		123	
General and administrative	2,169		1,638		531	
Total	$ 5,189		$ 3,675		$ 1,514	

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Sales and marketing expenses

The 10% increase in sales and marketing expenses in the first quarter of 2013 resulted primarily from an additional $2.1 million in compensation due to a higher number of sales personnel, primarily in NALA. The increase in headcount reflected our investment in sales and marketing resources aimed at expanding our customer base. The increase was partially offset by lower marketing expenses of $1.2 million in the first quarter of 2013 as a result of lower spend on brand development initiatives.

Research and development expenses

The 36% increase in research and development expense in the first quarter of 2013 was primarily due to no capitalization of labor and third party costs for development of internal-use software in the first quarter of 2013 as compared to $1.9 million capitalized costs in the first quarter of 2012. 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 enhance our Renew OnDemand platform. We anticipate that future capitalization of internal-use software costs will be insignificant.

General and administrative expenses

The 11% increase in general and administrative expense in the first quarter of 2013 as compared to the first quarter of 2012 reflected a $0.9 million increase in compensation, including stock-based compensation.

Income Tax Provision (Benefit)

	March 31,			%
	2013	2012	Change	Change
		(in thousands)		
Income tax provision (benefit)	$ 693	$ (1,950)	$ 2,643	136%

In first quarter of 2013, we recorded a charge to income tax expense of $0.1 million to establish a valuation allowance to offset deferred tax assets previously recognized with respect to our Ireland affiliate. The additional $0.6 million charge represents anticipated taxes in jurisdictions where we have profitable operations, including certain U.S. states, offset by limited benefits available from losses in Ireland. No benefit was otherwise provided for losses incurred in the U.S., Singapore and Japan, because these losses are offset by a full valuation allowance, as discussed below.

In first quarter of 2012, we recorded a one-time tax benefit of $1.3 million, resulting from the identification of U.S. Federal and California research credits recoverable for prior years. There were also one-time charges of $0.1 million arising from revisions of estimated tax expense in prior periods. Excluding the impact of these items, our effective tax rate for the three months ended March 31, 2012 was 24.7%. A valuation allowance was recognized in subsequent quarters to offset the benefits recognized in the first quarter of 2012.

Liquidity and Capital Resources

At March 31, 2013, we had cash, cash equivalents and short-term investments of $117.7 million, which primarily consisted of money market mutual funds, corporate bonds and U.S. government obligations held by well-capitalized financial institutions. Our primary operating cash requirements include the payment of compensation and related costs, working capital requirements related to accounts receivable and accounts payable, as well as costs for our facilities and information technology infrastructure. Historically, we have financed our operations principally from cash provided by our operating activities, proceeds from stock offerings and the exercise of stock options, and to a lesser extent, from borrowings under various credit facilities, with no such borrowings in 2013. We believe our existing cash and cash equivalents and short-term investments and our currently available credit facility will be sufficient to meet our working capital and capital expenditure needs for at least the next twelve months.

Credit Facility

On June 29, 2012, we terminated a revolving credit facility scheduled to expire in February 2013. The credit facility provided for a $20.0 million line of credit. At the time of termination, no borrowings other than a letter of credit in the face amount of $850,000 were outstanding under the credit facility.

On July 5, 2012, we entered into a new three-year credit agreement (the Credit Agreement). The Credit Agreement provides for a secured revolving line of credit based on eligible accounts receivable in an amount 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. Proceeds

available under the Credit Agreement may be used for working capital and other general corporate purposes. We have the option to prepay the loans under the Credit Agreement in whole or in part at any time without premium or penalty. We also have the option to 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.

The loans under the Credit Agreement bear interest, at our option, at a base rate determined in accordance with the Credit Agreement, minus 0.50%, or at a LIBOR rate plus 2.00%. Principal, together with all accrued and unpaid interest, is due and payable on July 5, 2015, the maturity date. We are also obligated to pay a quarterly commitment fee, payable in arrears, based on the available commitments.

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 our ability and our subsidiaries ability to grant liens, incur indebtedness, engage in mergers, consolidations and sales of assets and engage in affiliate transactions. The Credit Agreement requires us to maintain a maximum leverage ratio and a minimum liquidity amount, each as defined in the Credit 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 Credit Agreement to be immediately due and payable and exercise other rights and remedies provided for under the Credit Agreement.

Our obligations under the Credit Agreement are guaranteed by our subsidiary, ServiceSource Delaware, Inc., and are collateralized by substantially all of our assets and our subsidiary s assets.

Summary Cash Flows

The following table sets forth a summary of our cash flows for the periods indicated (in thousands):

	Three Months Ended March 31,	
	2013	**2012**
Net cash provided by (used in) operating activities	$ 5,880	$ (6,324)
Net cash used in investing activities	(18,258)	(8,701)
Net cash provided by financing activities	3,480	5,379
Net decrease in cash and cash equivalents, net of impact of foreign exchange changes on cash	$ (8,621)	$ (9,878)

Operating Activities

Net cash provided by operating activities was $5.9 million during the three months ended March 31, 2013. Net loss during the period was $10.5 million adjusted by non-cash charges of $3.2 million for depreciation and amortization and $5.9 million for stock-based compensation. Cash generated from operations during the three months ended March 31, 2013 resulted from sequential changes in our working capital including a $5.9 million decrease in accounts receivable, a $0.4 million decrease in prepaid expenses and other and a $2.1 million increase in accounts payable. Uses of cash were related to a $0.9 million decrease in accrued compensation and benefits and $0.8 million decrease in accrued taxes.

Net cash used in operating activities was $6.3 million during the three months ended March 31, 2012. Net loss during the period was $1.3 million adjusted by non-cash charges of $2.3 million for depreciation and amortization and $4.2 million for stock-based compensation. Cash used for operations during the three months ended March 31, 2012 resulted from changes in our working capital including a $6.8 million decrease in accrued compensation and benefits, a $5.1 million increase in accounts receivable, a $2.4 million increase in prepaid expenses and other and a $1.3 million decrease in accounts payable. Source of cash was related to a $3.8 million increase in other accrued liabilities.

Investing Activities

During the three months ended March 31, 2013 cash used in investing activities was principally for the purchases of short-term investments, net of sales and maturities, of $17.1 million, and to a lesser extent for property and equipment purchases, of $1.2 million. The $8.7 million of cash

used by investing activities during the three months ended March 31, 2012 related mostly to the purchase of property and equipment, including costs capitalized for development of internal-use software.

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Financing Activities

Cash provided by financing activities was $3.5 million during the three months ended March 31, 2013 principally resulted from proceeds of $3.7 million from the exercise of common stock options and the purchase of common stock under our employee stock purchase plan.

Cash provided by financing activities was $5.4 million during the three months ended March 31, 2012 principally resulted from proceeds of $5.8 million from the exercise of common stock options and the purchase of common stock under our employee stock purchase plan.

Off-Balance Sheet Arrangements

We do not have any relationships with other entities or financial partnerships, such as entities often referred to as structured finance or special-purpose entities, which have been established for the purpose of facilitating off-balance sheet arrangements or other contractually narrow or limited purposes.

Contractual Obligations and Commitments

Our principal commitments consist of obligations under operating leases for office space and computer equipment. At March 31, 2013, the future minimum payments under these commitments were as follows (in thousands):

	Total	Less than 1 year	1-3 years	3-5 years	More than 5 years
Obligations under capital leases	$ 868	$ 325	$ 347	$ 196	$
Operating lease obligations	38,811	7,869	15,434	10,180	5,328
	$ 39,679	$ 8,194	$ 15,781	$ 10,376	$ 5,328

The contractual commitment amounts in the table above are associated with agreements that are enforceable and legally binding, which specify significant terms including payment terms, related services and the approximate timing of the transaction. Obligations under contracts that we can cancel without a significant penalty are not included in the table above.

Also excluded from the table above is the income tax liability we recorded for the difference between the benefit recognized and measured and the tax position taken or expected to be taken on our tax returns (unrecognized tax benefits). As of March 31, 2013, our liability for unrecognized tax benefits was $0.1 million. Reasonably reliable estimates of the amounts and periods of related future payments cannot be made at this time.

Critical Accounting Policies and Estimates

Management has determined that our most critical accounting policies are those related to revenue recognition, stock-based compensation, capitalized internal-use software and income taxes. We continue to monitor our accounting policies to ensure proper application of current rules and regulations. There have been no material changes in our critical accounting policies and estimates during the three months ended March 31, 2013 as compared to the critical accounting policies and estimates disclosed in Management s Discussion and Analysis of Financial Condition and Results of Operations Critical Accounting Policies and Estimates of our Annual Report on Form 10-K for the year ended December 31, 2012 as filed with the Securities and Exchange Commission on March 8, 2013.

Recent Accounting Pronouncements

The information contained in Note 1 to our condensed consolidated financial statements in Item 1 under the heading, Recently Adopted Accounting Pronouncements, is incorporated by reference into this Item 2.

Item 3. ***Quantitative and Qualitative Disclosures About Market Risk***

We believe that there have been no significant changes in our market risk exposures for the three months ended March 31, 2013, as compared with those discussed in our Annual Report on Form 10-K for the fiscal year ended December 31, 2012.

Item 4. ***Controls and Procedures***

(a) Evaluation of Disclosure Controls and Procedures

Under the supervision and with the participation of our management, including our principal executive officer and principal financial officer, we conducted an evaluation of the effectiveness of the design and operation of our disclosure controls and procedures, as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the Exchange Act) of the end of the period covered by this report (the Evaluation Date).

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In designing and evaluating our disclosure controls and procedures, management recognizes that any disclosure controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives. In addition, the design of disclosure controls and procedures must reflect the fact that there are resource constraints and that management is required to apply its judgment in evaluating the benefits of possible controls and procedures relative to their costs.

Based on management s evaluation, our chief executive officer and chief financial officer concluded that our disclosure controls and procedures are designed to, and are effective to, provide assurance at a reasonable level that the information we are required to disclose in reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in Securities and Exchange Commission rules and forms, and that such information is accumulated and communicated to our management, including our chief executive officer and chief financial officer, as appropriate, to allow timely decisions regarding required disclosures.

(b) Management s Report on Internal Control Over Financial Reporting

Under the supervision and with the participation of our management, including our principal executive officer and principal financial officer, we conducted an evaluation of any changes in our internal control over financial reporting (as such term is defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) that occurred during our most recently completed fiscal quarter. Based on that evaluation, our principal executive officer and principal financial officer concluded that there has not been any material change in our internal control over financial reporting during the quarter covered by this report that materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

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PART II OTHER INFORMATION

Item 1. ***Legal Proceedings***

From time to time, we are subject to litigation or threatened litigation in the general nature of business. We do not believe the resolution of these matters will have a material adverse impact on our consolidated results of operations, cash flows or financial position.

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

Investing in our common stock involves a high degree of risk. You should carefully consider the risks described below and the other information in this Quarterly Report on Form 10-Q. If any of the following risks are realized, our business, financial condition, results of operations, cash flows, the trading price of our common stock could be materially and adversely affected. The risks described below are not the only risks facing us. Risks and uncertainties not currently known to us or that we currently deem to be immaterial may also materially affect our business, financial condition, results of operations, cash flows, the trading price of our common stock.

Risks Related to Our Business and Industry

Our quarterly results of operations may fluctuate as a result of numerous factors, many of which may be outside of our control.

Our quarterly operating results are likely to fluctuate. Some of the important factors that may cause our revenue, operating results and cash flows to fluctuate from quarter to quarter include:

- our ability to attract new customers;
- our ability to retain existing customers and/or maintain the size of our engagements with those customers;
- the renewal rates we achieve early in an engagement and the time it takes to achieve the close rates expected for the term of the engagement;
- our ability to effectively sell and implement Renew OnDemand;
- fluctuations in the value of end customer contracts delivered to us;
- fluctuations in close rates;
- changes in our commission rates;
- seasonality;
- loss of customers for any reason including due to acquisition;

the mix of new customers as compared to existing customers;

the length of the sales cycle for our solution, and our level of upfront investments prior to the period we begin generating revenue associated with such investments;

the timing of customer payments and payment defaults by customers;

the amount and timing of operating costs and capital expenditures related to the operations of our business, including the development of new technologies such as Renew OnDemand;

the rate of expansion, productivity and realignment of our direct sales force;

the cost and timing of the introduction of new technologies or new services, including additional investments in Renew OnDemand;

general economic conditions;

technical difficulties or interruptions in delivery of our solution;

changes in foreign currency exchange rates;

changes in tax rates;

regulatory compliance costs, including with respect to data privacy;

costs associated with acquisitions of companies and technologies;

extraordinary expenses such as litigation or other dispute-related settlement payments; and

the impact of new accounting pronouncements.

Many of the above factors are discussed in more detail elsewhere in these Risk Factors. Many of these factors are outside our control, and the variability and unpredictability of such factors could result in our failing to meet our revenue or operating results expectations for a given period. In addition, the occurrence of one or more of these factors might cause our operating results to vary widely which could lead to negative impacts on our margins, short-term liquidity or ability to retain or attract key personnel, and could cause other unanticipated issues. Accordingly, we believe that quarter-to-quarter comparisons of our revenue, operating results and cash flows may not be meaningful and should not be relied upon as an indication of future performance.

Our customer relationships and overall business will suffer if we encounter significant problems migrating customers to our next-generation technology platform, or if the new platform does not meet expectations.

We recently introduced Renew OnDemand, our next-generation service revenue management platform. This new platform is offered on a subscription basis and will be the core foundation for our customer-facing cloud applications, in addition to applications we use for our internal operations. As of today, Renew OnDemand is largely unproven and we have little experience selling and/or implementing it for customers. We also have limited experience migrating customers from one platform to another. Given the complexity and significance of this transition, including as a result of the amount of customer data within our systems that will need to be accessed and migrated, our customer relationships, our reputation, and our overall business could be severely damaged if our implementations or migrations are poorly executed. In addition, we expect to incur additional expenses as a result of our near term plans to run dual technology platforms for several quarters as we move toward broad adoption of Renew OnDemand while maintaining our existing technology platform. Additionally, if we experience any delay or technical problems as a result of moving to Renew OnDemand, we may incur such expenses for much longer than anticipated. Similarly, even if the transition to Renew OnDemand is properly executed, our business operations and customer relationships will be at high risk if the new platform does not meet our performance expectations, or those of our customers. This could harm our business in numerous ways including, without limitation, a loss of revenue and customer contracts and damage to our reputation.

Our revenue will decline if there is a decrease in the overall demand for our customers products and services for which we provide service revenue management.

Our revenue is based on a pay-for-performance model under which we are paid a commission based on the service contracts we sell on behalf of our customers. If a particular customer s products or services fail to appeal to its end customers, our revenue may decline. In addition, if end customer demand decreases for other reasons, such as negative news regarding our customers or their products, unfavorable economic conditions, shifts in strategy by our customers away from promoting the service contracts we sell in favor of selling their other products or services to their end customers, or if end customers experience financial constraints and fail to renew the service contracts we sell, we may experience a decrease in our revenue as the demand for our customers service contracts declines. Similarly, if our customers come under economic pressure, they may be more likely to terminate their contracts with as and/or seek to restructure those contracts, and for customers whose contracts are up for renewal, they may seek to renew those contracts on less favorable terms.

The market for our solution is relatively undeveloped and may not grow.

The market for service revenue management is still relatively undeveloped, has not yet achieved widespread acceptance and may not grow quickly or at all. Our success will depend to a substantial extent on the willingness of companies to engage a third party such as us to manage the sales of their support, maintenance and subscription contracts. Many companies have invested substantial personnel, infrastructure and financial resources in their own internal service revenue organizations or in some cases have built or modified software applications to help manage renewals and therefore may be reluctant to switch to a solution such as ours. Companies may not engage us for other reasons, including a desire to maintain control over all aspects of their sales activities and customer relations, concerns about end customer reaction, a belief that they can sell their support, maintenance and subscription services more cost-effectively using their internal sales organizations, perceptions about the expenses associated with changing to a new approach and the timing of expenses once they adopt a new approach, general reluctance to adopt any new and different approach to old ways of doing business, or other considerations that may not always be evident. New concerns or considerations may also emerge in the future. Particularly because our market is relatively undeveloped, we must address our potential customers concerns and explain the benefits of our approach in order to convince them to change the way that they manage the sales of support, maintenance and subscription contracts. If companies are not sufficiently convinced that we can address their concerns and that the benefits of our solution are compelling, then the market for our solution may not develop as we anticipate and our business will not grow.

Delayed or unsuccessful investment in new technology, services and markets may harm our financial results.

We plan to continue investing significant resources in research and development in order to enhance Renew OnDemand, our managed services offerings, and other new offerings that will appeal to customers and potential customers. We have

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undertaken the development of Renew OnDemand as our new technology to offer improved and more scalable service revenue management, including enhancements to our applications. The development of new products and services entails a number of risks that could adversely affect our business and operating results, including:

- the risk of diverting the attention of our management and our employees from the day-to-day operations of the business;
- insufficient revenue to offset increased expenses associated with research, development, operational and marketing activities; and
- write-offs of the value of such technology investments as a result of unsuccessful implementation or otherwise.

If Renew OnDemand or any of our other new or modified technology does not work as intended, is not responsive to user preferences or industry or regulatory changes, is not appropriately timed with market opportunity, or is not effectively brought to market, we may lose existing and potential customers or related service revenue opportunities, in which case our results of operations may suffer. The cost of future development of new service revenue management offerings or technologies also could require us to raise additional debt or equity financing. These actions could be dilutive to our existing stockholders and negatively impact our financial condition or our results of operations.