

SERVICESOURCE INTERNATIONAL, INC.

Form 10-Q

May 10, 2013

Table of Contents

**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**FORM 10-Q**

(Mark One)

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

For the quarterly period ended March 31, 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)

Edgar Filing: SERVICESOURCE INTERNATIONAL, INC. - Form 10-Q

|  |  |
|--|--|
| <b>Delaware</b><br>(State or Other Jurisdiction of<br>Incorporation or Organization)                         | <b>No. 81-0578975</b><br>(I.R.S. Employer<br>Identification No.) |
| <b>634 Second Street</b><br><br><b>San Francisco, California</b><br>(Address of Principal Executive Offices) | <b>94107</b><br>(Zip Code)                                       |
| <b>(415) 901-6030</b><br>(Registrant's Telephone Number, Including Area Code)                                |  |

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

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

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

|  |   |
|--|---|
| Large accelerated filer <input type="checkbox"/>   | Accelerated filer <input checked="" type="checkbox"/> |
| Non-accelerated filer <input type="checkbox"/> (Do not check if a smaller reporting company) | Smaller reporting company <input type="checkbox"/>    |

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

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

| Class        | Outstanding as of April 30, 2013 |
|--------------|----------------------------------|
| Common Stock | 76,823,424                       |

**Table of Contents**

**SERVICESOURCE INTERNATIONAL, INC.**

**Form 10-Q**

**INDEX**

|  | <b>Page<br/>No.</b> |
|--|---------------------|
| <b>PART I. FINANCIAL INFORMATION</b>   |                     |
| <u>Item 1. Financial Statements (unaudited)</u>  | 3                   |
| <u>Condensed Consolidated Balance Sheets as of March 31, 2013 and December 31, 2012</u>                                    | 3                   |
| <u>Condensed Consolidated Statements of Operations for the three months ended March 31, 2013 and 2012</u>                  | 4                   |
| <u>Condensed Consolidated Statements of Comprehensive Income (Loss) for the three months ended March 31, 2013 and 2012</u> | 5                   |
| <u>Condensed Consolidated Statements of Cash Flows for the three months ended March 31, 2013 and 2012</u>                  | 6                   |
| <u>Notes to Unaudited Condensed Consolidated Financial Statements</u>  | 7                   |
| <u>Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations</u>                       | 16                  |
| <u>Item 3. Quantitative and Qualitative Disclosures About Market Risk</u>  | 25                  |
| <u>Item 4. Controls and Procedures</u>   | 25                  |
| <b>PART II. OTHER INFORMATION</b>  |                     |
| <u>Item 1. Legal Proceedings</u>   | 27                  |
| <u>Item 1A. Risk Factors</u>   | 27                  |
| <u>Item 2. Unregistered Sales of Equity Securities and Use of Proceeds</u>   | 42                  |
| <u>Item 3. Default Upon Senior Securities</u>  | 42                  |
| <u>Item 4. Mine Safety Disclosures</u>   | 42                  |
| <u>Item 5. Other Information</u>   | 42                  |
| <u>Item 6. Exhibits</u>  | 42                  |
| <u>Signatures</u>  | 43                  |
| <u>Exhibit Index</u>   | 44                  |

**Table of Contents****PART I FINANCIAL INFORMATION****Item 1. Financial Statements****SERVICESOURCE INTERNATIONAL, INC.****CONDENSED CONSOLIDATED BALANCE SHEETS****(In thousands)****(Unaudited)**

|  | <b>March 31,<br/>2013</b> | <b>December 31,<br/>2012</b> |
|--|---------------------------|------------------------------|
| <b>Assets</b>  |                           |                              |
| 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                   |
| <b>Liabilities and Stockholders' Equity</b>  |                           |                              |
| 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)                     |

Edgar Filing: SERVICESOURCE INTERNATIONAL, INC. - Form 10-Q

|  |            |            |
|--|------------|------------|
| 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.

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

|  | <b>Three Months Ended<br/>March 31,</b> |                   |
|--|---|-------------------|
|  | <b>2013</b>                             | <b>2012</b>       |
| Net revenue  | \$ 61,121                               | \$ 57,574         |
| Cost of revenue  | 38,498                                  | 32,576            |
| <b>Gross profit</b>  | <b>22,623</b>                           | <b>24,998</b>     |
| 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)           |
| <b>Net loss</b>  | <b>\$ (10,455)</b>                      | <b>\$ (1,276)</b> |
| 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.

**Table of Contents**

**SERVICESOURCE INTERNATIONAL, INC.**

**CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)**

**(In thousands)**

**(Unaudited)**

|   | <b>Three Months Ended<br/>March 31,</b> |             |
|---|---|-------------|
|   | <b>2013</b>                             | <b>2012</b> |
| 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.

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

|   | <b>Three Months Ended<br/>March 31,</b> |             |
|---|---|-------------|
|   | <b>2013</b>                             | <b>2012</b> |
| <b>Cash flows from operating activities</b>   |   |             |
| 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)     |
| <b>Cash flows from investing activities</b>   |   |             |
| 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)     |
| <b>Cash flows from financing activities</b>   |   |             |
| 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.





---

**Table of Contents**

**SERVICESOURCE INTERNATIONAL, INC.**

**NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**Note 1 Description of Business and Basis of Presentation**

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

The accompanying unaudited interim condensed consolidated financial statements ( condensed consolidated financial statements ) include the accounts of ServiceSource International Inc. and its subsidiaries ( SSI or Company ). Intercompany accounts and transactions have been eliminated in consolidation.

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

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

**Recent Accounting Pronouncements**

In February 2013, the Financial Accounting Standards Board ( FASB ) issued Accounting Standards Update ( ASU ) No. 2013-02 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.



**Table of Contents**

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<br>Cost | Unrealized<br>Gains | Unrealized<br>Losses | Estimated<br>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<br>Cost | Unrealized<br>Gains | Unrealized<br>Losses | Estimated<br>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:

Edgar Filing: SERVICESOURCE INTERNATIONAL, INC. - Form 10-Q

|                     | Amortized<br>Cost | Estimated<br>Fair Value |
|---------------------|-------------------|-------------------------|
| Less than 1 year    | \$ 3,169          | \$ 3,169                |
| Due in 1 to 3 years | 46,566            | 46,586                  |
| <b>Total</b>        | <b>\$ 49,735</b>  | <b>\$ 49,755</b>        |

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.

**Table of Contents**

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):

| Description                                 | Total     | Quoted Prices<br>in Active<br>Markets for<br>Identical<br>Assets<br>(Level 1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
|---|-----------|---|---|--|
| <b>Cash equivalents:</b>                    |           |   |   |  |
| Money market mutual funds                   | \$ 113    | \$ 113  | \$  | \$   |
| Total cash equivalents                      | 113       | 113   |   |  |
| <b>Short-term investments:</b>              |           |   |   |  |
| 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):

| Description                    | Total     | Quoted Prices<br>in Active<br>Markets for<br>Identical<br>Assets<br>(Level 1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
|--------------------------------|-----------|---|---|--|
| <b>Cash equivalents:</b>       |           |   |   |  |
| Money market mutual funds      | \$ 17,000 | \$ 17,000   | \$  | \$   |
| Total cash equivalents         | 17,000    | 17,000  |   |  |
| <b>Short-term investments:</b> |           |   |   |  |
| Corporate bonds                | 13,377    |   | 13,377  |  |
| U.S. agency securities         | 11,283    |   | 11,283  |  |

Edgar Filing: SERVICESOURCE INTERNATIONAL, INC. - Form 10-Q

|   |           |           |           |    |
|---|-----------|-----------|-----------|----|
| 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.

**Table of Contents****Note 4 Property and Equipment, Net**

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

|   | March 31,<br>2013 | December 31,<br>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,<br>2013 | December 31,<br>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



## Edgar Filing: SERVICESOURCE INTERNATIONAL, INC. - Form 10-Q

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%.

**Table of Contents**

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):

|                                  | <b>March 31,<br/>2013</b> |
|----------------------------------|---------------------------|
| <b>Years Ending December 31,</b> |                           |
| 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**

Edgar Filing: SERVICESOURCE INTERNATIONAL, INC. - Form 10-Q

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

## **Table of Contents**

### **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

**Table of Contents**

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<br>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<br>Available<br>for Grant | Options Outstanding |   | Restricted Stock<br>Outstanding |
|---|--|---------------------|---|---------------------------------|
|   |  | Number<br>of Shares | Weighted-<br>Average<br>Exercise<br>Price | Number<br>of Shares             |
| <b>Outstanding December 31, 2012</b>                            | 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)                           |
| <b>Outstanding March 31, 2013</b>                               | 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    |

Edgar Filing: SERVICESOURCE INTERNATIONAL, INC. - Form 10-Q

|                                |          |          |
|--------------------------------|----------|----------|
| 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.

**Table of Contents**

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<br>March 31, 2013 | Three Months Ended<br>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, 2012 management assessed the realizability of deferred tax assets based on the available evidence, including a history of taxable income and estimates of future taxable income. Management believes that it is not more likely than not that the deferred tax assets will be realized with respect to US federal and state deferred tax assets, except for certain U.S. state deferred tax assets where the Company's subsidiary has profitable operations. Accordingly, a valuation allowance was provided with respect to U.S. federal and most U.S. State deferred tax assets. A valuation allowance was also provided with respect to deferred tax assets from its Singapore, 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.

Edgar Filing: SERVICESOURCE INTERNATIONAL, INC. - Form 10-Q

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



**Table of Contents**

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):

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

**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.



**Table of Contents****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



## **Table of Contents**

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.



## **Table of Contents**

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.



## **Table of Contents**

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.

**Table of Contents****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.

|                                       | <b>Three Months Ended</b> |                   |
|---------------------------------------|---------------------------|-------------------|
|                                       | <b>March 31,</b>          |                   |
|                                       | <b>2013</b>               | <b>2012</b>       |
|                                       | <b>(in thousands)</b>     |                   |
| Net revenue                           | \$ 61,121                 | \$ 57,574         |
| Cost of revenue                       | 38,498                    | 32,576            |
| <b>Gross profit</b>                   | <b>22,623</b>             | <b>24,998</b>     |
| 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)           |
| <b>Net loss</b>                       | <b>\$ (10,455)</b>        | <b>\$ (1,276)</b> |
| Includes stock-based compensation of: |                           |                   |
| Cost of revenue                       | \$ 732                    | \$ 572            |

Edgar Filing: SERVICESOURCE INTERNATIONAL, INC. - Form 10-Q

|                                |          |          |
|--------------------------------|----------|----------|
| 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 |

**Table of Contents**

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

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

**Table of Contents****Net Revenue**

|                           | Three Months Ended March 31,<br>2013 |                     | 2012                     |                     | Change          | %<br>Change |
|---------------------------|--------------------------------------|---------------------|--------------------------|---------------------|-----------------|-------------|
|                           | Amount                               | % of<br>Net Revenue | Amount<br>(in thousands) | % of<br>Net Revenue |                 |             |
| 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%          |
| <b>Total net revenue</b>  | <b>\$ 61,121</b>                     | <b>100%</b>         | <b>\$ 57,574</b>         | <b>100%</b>         | <b>\$ 3,547</b> | <b>6%</b>   |

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, |                        | Change   | %<br>Change |
|---------------------------------------|------------------------------|------------------------|----------|-------------|
|                                       | 2013                         | 2012<br>(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,<br>2013 |                     | 2012                     |                     | Change   | %<br>Change |
|----------------------------|--------------------------------------|---------------------|--------------------------|---------------------|----------|-------------|
|                            | Amount                               | % of<br>Net Revenue | Amount<br>(in thousands) | % of<br>Net Revenue |          |             |
| 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%         |

Edgar Filing: SERVICESOURCE INTERNATIONAL, INC. - Form 10-Q

|                                       |           |     |           |     |          |     |
|---------------------------------------|-----------|-----|-----------|-----|----------|-----|
| 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 |     |

**Table of Contents***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   | %      |
|                                | (in thousands) |            |          | Change |
| 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.

## Edgar Filing: SERVICESOURCE INTERNATIONAL, INC. - Form 10-Q

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



**Table of Contents**

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):

|  | <b>Three Months Ended<br/>March 31,</b> |             |
|--|---|-------------|
|  | <b>2013</b>                             | <b>2012</b> |
| 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

Edgar Filing: SERVICESOURCE INTERNATIONAL, INC. - Form 10-Q

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.

**Table of Contents****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):

|                                  | <b>Total</b> | <b>Less than 1<br/>year</b> | <b>1-3 years</b> | <b>3-5 years</b> | <b>More than 5<br/>years</b> |
|----------------------------------|--------------|-----------------------------|------------------|------------------|------------------------------|
| 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 ).

**Table of Contents**

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.

**Table of Contents**

**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;

## Edgar Filing: SERVICESOURCE INTERNATIONAL, INC. - Form 10-Q

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.

---

**Table of Contents**

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 us 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





---

## **Table of Contents**

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.

***We plan to sell subscriptions to our cloud applications via Renew OnDemand separately from our integrated solution, which may not be successful and could impact revenue from our existing solution.***

We currently derive a small portion of our revenue from subscriptions to our cloud applications for a few customers, and we plan to package and price the applications we offer on Renew OnDemand on a subscription model. We may not find a successful market for our Renew OnDemand subscription applications. In addition, because we have limited prior experience selling technology subscriptions on a stand-alone basis, we may encounter technical and execution challenges that undermine the quality of the technology offering or cause us to fall short of customer expectations. We also have little experience pricing our technology subscriptions separately, which could result in under pricing that damages our profit margins and financial performance. It is also possible that selling a technology solution separate via Renew OnDemand from our integrated solution will result in a reduction in sales of our current offerings that we might otherwise have sold. An unsuccessful expansion of our business to promote a stand-alone subscription model for any of the foregoing reasons or otherwise would lead to a diversion of financial and managerial resources from our existing business and an inability to generate sufficient revenue to offset our investment costs.

***Our estimates of service revenue opportunity under management and other metrics may prove inaccurate.***

We use various estimates in formulating our business plans and analyzing our potential and historical performance, including our estimate of service revenue opportunity under management. We base our estimates upon a number of assumptions that are inherently subject to significant business and economic uncertainties and contingencies, many of which are beyond our control. Our estimates therefore may prove inaccurate.

Service revenue opportunity under management ( opportunity under management ) is a forward-looking metric and is our estimate, as of a given date, of the value of all end customer service contracts that we will have the opportunity to sell on behalf of our customers over the subsequent twelve-month period. Opportunity under management is not a measure of our expected revenue. We estimate the value of such end customer contracts based on a combination of factors, including the value of end-customer contracts made available to us by customers in past periods; the minimum value of end-customer contracts that our customers are required to give us the opportunity to sell pursuant to the terms of their contracts with us; periodic internal business reviews of our expectations as to the value of end customer contracts that will be made available to us by customers; the value of end customer contracts included in the SPA; and, collaborative discussions with our customers assessing their expectations as to the value of service contracts that they will make available to us for sale. While the minimum value of end customer contracts that our customers are required to give us represents a portion of our estimated opportunity under management, a significant portion of the opportunity under management is estimated based on the other factors described above.

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

the extent to which customers deliver a greater or lesser value of end customer contracts than may be required or otherwise expected;

roll-overs of unsold service contract renewals from prior periods to the current period or future periods;

## Table of Contents

changes in the pricing or terms of service contracts offered by our customers;

increases or decreases in the end customer base of our customers;

the extent to which the renewal rates we achieve on behalf of a customer early in an engagement affect the amount of opportunity that the customer makes available to us later in the engagement;

customer cancellations of their contracts with us due to acquisitions or otherwise; and

changes in our customers' businesses, sales organizations, sales processes or priorities, including changes in executive support for our partnership.

In addition, opportunity under management reflects our estimate for a forward twelve-month period and should not be used to estimate our opportunity for any particular quarter within that period.

***If our security measures are breached or fail, resulting in unauthorized access to customer data, our solution may be perceived as insecure, the attractiveness of our solution to current or potential customers may be reduced and we may incur significant liabilities.***

Our solution involves the storage and transmission of the proprietary information and protected data that we receive from our customers. We rely on proprietary and commercially available systems, software, tools and monitoring, as well as other processes, to provide security for processing, transmission and storage of such information. If our security measures are breached or fail as a result of third-party action, employee negligence, error, malfeasance or otherwise, unauthorized access to customer or end customer data may occur. Improper activities by third parties, advances in computer and software capabilities and encryption technology, new tools and discoveries and other events or developments may facilitate or result in a compromise or breach of our computer systems. Techniques used to obtain unauthorized access or to sabotage systems change frequently and generally are not recognized until launched against a target, and we may be unable to anticipate these techniques or implement adequate protective measures. Our security measures may not be effective in preventing these types of activities, and the security measures of our third-party data centers and service providers may not be adequate.

Our customer contracts generally provide that we will indemnify our customers for data privacy breaches. If such a breach occurs, we could face contractual damages, damages and fees arising from our indemnification obligations, penalties for violation of applicable laws or regulations, possible lawsuits by affected individuals and significant remediation costs and efforts to prevent future occurrences. In addition, whether there is an actual or a perceived breach of our security, the market perception of the effectiveness of our security measures could be harmed significantly and we could lose current or potential customers.

***We may be liable to our customers or third parties if we make errors in providing our solution or fail to properly safeguard their confidential information.***

The solution we offer is complex, and we make errors from time to time. These may include human errors made in the course of managing the sales process for our customers as we interact with their end customers, or errors arising from our technology solution as it interacts with our customers' systems and the disparate data contained on such systems. Errors may also arise from the launch of and migration of our offerings to Renew OnDemand. The costs incurred in correcting any material errors may be substantial. In addition, as part of our business, we collect, process and analyze confidential information provided by our customers and prospective customers. Although we take significant steps to safeguard the confidentiality of customer information, we could be subject to claims that we disclosed their information without appropriate authorization or used their information inappropriately. Any claims based on errors or unauthorized disclosure or use of information could subject us to exposure for damages, significant legal defense costs, adverse publicity and reputational harm, regardless of the merits or eventual outcome of such claims.

***If close rates fall short of our estimates, our customer relationships will be at risk, our revenue will suffer and our ability to grow and achieve broader market acceptance of our solution could be harmed.***

Given our pay-for-performance pricing model, our revenue is directly tied to close rates. Close rates represent the percentage of the actual opportunity delivered that we renew on behalf of our customers. If the close rate for a particular customer is lower than anticipated, then our

revenue for that customer will also be lower than projected. If close rates fall short of expectations across a broad range of customers, or if they fall below expectations for a particularly large customer, then the impact on our revenue and our overall business will be significant. In the event close rates are lower than expected for a given customer, our margins will suffer because we will have already incurred a certain level of costs in both personnel and infrastructure to support the engagement. This risk is compounded by the fact that many of our customer relationships are terminable if we fail to meet certain specified sales targets over a sustained period of time. If actual close rates fall to a level at which our revenue and customer contracts are at risk, then our financial performance will decline and we will be severely compromised in our ability to retain and attract new customers. Increasing our customer base and achieving broader market acceptance of our solution

## Table of Contents

depends, to a large extent, on how effectively our solution increases service sales. As a result, poor performance with respect to our close rates, in addition to causing our revenue, margins and earnings to suffer, will likely damage our customer relationships and overall reputation, and prevent us from effectively developing and maintaining awareness of our brand or achieving widespread acceptance of our solution, in which case we could fail to grow our business and our revenue, margins and earnings would suffer.

*If we are unable to compete effectively against current and future competitors, our business and operating results will be harmed.*

The market for service revenue management is evolving. Historically, technology companies have managed their service renewals through internal personnel and relied upon technology ranging from Excel spreadsheets to internally-developed software to customized versions of traditional business intelligence tools and CRM or ERP software from vendors such as Oracle, SAP, salesforce.com and NetSuite. Some companies have made further investments in this area using firms such as Accenture and McKinsey for technology consulting and education services focused on service renewals. These internally-developed solutions represent the primary alternative to our offerings. We also face direct competition from smaller companies that offer specialized service revenue management solutions, typically providing technology for use by their customers' internal sales personnel.

We believe the principal competitive factors in our markets include the following:

service revenue industry expertise, best practices, and benchmarks;

quality and reliability of software offerings;

marketing resources and capabilities;

performance-based pricing of solutions;

ability to increase service revenue, renewal rates, and close rates;

global capabilities;

completeness of solution;

ability to effectively represent customer brands to end customers and channel partners;

size of upfront investment; and

size and financial stability of operations.

We believe that more competitors will emerge. These competitors may have greater name recognition, longer operating histories, well-established relationships with customers in our markets and substantially greater financial, technical, personnel and other resources than we have. Potential competitors of any size may be able to respond more quickly and effectively than we can to new or changing opportunities, technologies, standards or customer or end customer requirements. Even if our solution is more effective than competing solutions, potential customers might choose new entrants unless we can convince them of the advantages of our integrated solution. We expect competition and competitive pressure, from both new and existing competitors, to increase in the future.

***If there is a widespread shift away from business customers purchasing maintenance and support service contracts, we could be adversely impacted if we are not able to adapt to new trends or expand our target markets.***

As a result of our historical concentration in the software and hardware industries, a significant portion of our revenue comes from the sale of maintenance and support service contracts for the software and hardware products used by our customers' end customers. Although we also sell other types of renewals, such as subscriptions to software-as-a-service offerings, those sales have to date constituted a relatively small portion of our revenue. The emergence of cloud computing and other alternative technology purchasing models, in which technology services are provided on a remote-access basis, may have a significant impact on the size of the market for traditional maintenance and support contracts. If these alternative models continue gaining traction and reduce the size of our traditional market, we will need to continue to adapt our solution to capitalize on these trends or our results of operations will suffer.

***The loss of one or more of our key customers could slow our revenue growth or cause our revenue to decline.***

A substantial portion of our revenue has to date come from a relatively small number of customers. During the three months ended March 31, 2013, our top ten customers accounted for 49% of our revenue with one customer representing over 10% of our revenue. A relatively small number of customers may continue to account for a significant portion of our revenue for the foreseeable future. The loss of any of our significant customers for any reason, including the failure to renew our contracts, a change of relationship with any of our key customers or their acquisition as discussed below, may cause a significant decrease in our revenue.

## **Table of Contents**

***Supporting our existing and growing customer base could strain our personnel resources and infrastructure, and if we cannot scale our operations and increase productivity, we may be unsuccessful in implementing our business plan.***

Anticipated growth in our customer base will place a strain on our management, administrative, operational and financial infrastructure. We expect that additional investments in sales personnel, information technology, infrastructure and research and development spending will be required to:

further develop and enhance Renew OnDemand and our other offerings;

address the needs of our customers;

scale our operations and increase productivity;

develop new technology; and

expand our markets and opportunity under management, including into new industry verticals and geographic areas.

Our success will depend in part upon our ability to manage our growth effectively. To do so, we must continue to increase the productivity of our existing employees and to hire, train and manage new employees as needed. To manage domestic and international growth of our operations and personnel, we will need to continue to improve our operational, financial and management controls and our reporting processes and procedures, and implement more extensive and integrated financial and business information systems. These additional investments will increase our operating costs, which will make it more difficult for us to offset any future revenue shortfalls by reducing expenses in the short term. Moreover, if we fail to scale our operations successfully and increase productivity, our overall business will be at risk.

***Consolidation in the technology sector is continuing at a rapid pace, which could harm our business in the event that our customers are acquired and their contracts are cancelled.***

Consolidation among technology companies in our target market has been robust in recent years, and this trend poses a risk for us. Acquisitions of our customers could lead to cancellation of our contracts with those customers by the acquiring companies and could reduce the number of our existing and potential customers. For example, Oracle has acquired a number of our customers in recent years, including our then-largest customer, Sun Microsystems, in January 2010. Oracle has elected to terminate our service contracts with each customer because Oracle conducts its service revenue management internally. If mergers and acquisitions continue, we expect that some of the acquiring companies, and Oracle in particular, will terminate, renegotiate and/or elect not to renew our contracts with the companies they acquire, which would reduce our revenue.

***We enter into long-term, commission-based contracts with our customers, and our failure to correctly price these contracts may negatively affect our profitability.***

We enter into long-term contracts with our customers that are priced based on multiple factors determined in large part by the SPA we conduct for our customers. These factors include opportunity size, anticipated close rates and expected commission rates at various levels of sales performance. Some of these factors require forward-looking assumptions that may prove incorrect. If our assumptions are inaccurate, or if we otherwise fail to correctly price our customer contracts, particularly those with lengthy contract terms, then our revenue, profitability and overall business operations may suffer. Further, if we fail to anticipate any unexpected increase in our cost of providing services, including the costs for employees, office space or technology, we could be exposed to risks associated with cost overruns related to our required performance under our contracts, which could have a negative effect on our margins and earnings.

***Many of our customer contracts allow termination for our failure to meet certain performance conditions.***

Although most of our customer contracts are subject to multi-year terms, these agreements often have termination rights if we fail to meet specified sales targets. During the SPA and contract negotiation phase with a customer, we typically negotiate minimum performance levels for



the engagement. If we fail to meet our required targets and our customers choose to exercise their termination rights, our revenue could decline. These termination rights may also create instability in our revenue forecasts and other forward looking financial metrics.

***Our business may be harmed if our customers rely upon our service revenue forecasts in their business and actual results are materially different.***

The contracts that we enter into with our customers provide for sharing of information with respect to forecasts and plans for the renewal of maintenance, support and subscription agreements of our customers. Our customers may use such forecasted data for a variety of purposes related to their business. Our forecasts are based upon the data our customers provide to us, and are inherently subject to significant business, economic and competitive uncertainties, many of which are beyond our control.

## **Table of Contents**

In addition, these forecasted expectations are based upon historical trends and data that may not be true in subsequent periods. Any material inaccuracies related to these forecasts could lead to claims on the part of our customers related to the accuracy of the forecasted data we provide to them, or the appropriateness of our methodology. Any liability that we incur or any harm to our brand that we suffer because of inaccuracies in the forecasted data we provide to our customers could impact our ability to retain existing customers and harm our business.

### ***Changing global economic conditions and large scale economic shifts may impact our business.***

Our overall performance depends in part on worldwide economic conditions that impact the technology sector and other technology-enabled industries such as healthcare, life sciences and industrial systems. For example, the recent economic downturn resulted in many businesses deferring technology investments, including purchases of new software, hardware and other equipment, and purchases of additional or supplemental maintenance, support and subscription services. To a certain extent, these businesses also slowed the rate of renewals of maintenance, support and subscription services for their existing technology base. A future downturn could cause business customers to stop renewing their existing maintenance, support and subscription agreements or contracting for additional maintenance services as they look for ways to further cut expenses, in which case our business could suffer.

Conversely, a significant upturn in global economic conditions could cause business purchasers to purchase new hardware, software and other technology products, which we generally do not sell, instead of renewing or otherwise purchasing maintenance, support and subscription services for their existing products. A general shift toward new product sales could reduce our near term opportunities for these contracts, which could lead to a decline in our revenue.

### ***Our inability to expand our target markets could adversely impact our business and operating results.***

We derive substantially all of our revenue from customers in certain sectors in the technology and technology-enabled healthcare and life sciences industries, and an important part of our strategy is to expand our existing customer base and win new customers in these industries. In addition, because of the service revenue opportunities that we believe exist beyond these industries, we intend to target new customers in additional industry vertical markets, such as technology-enabled building services. In connection with the expansion of our target markets, we may not have familiarity with such additional industry verticals, and our execution of such expansion could face risks where our experience base is less developed within a particular new vertical. We may encounter customers in these previously untapped markets that have different pricing and other business sensitivities than we are used to managing. As a result of these and other factors, our efforts to expand our solution to additional industry vertical markets may not succeed, may divert management resources from our existing operations and may require us to commit significant financial resources to unproven parts of our business, all of which may harm our financial performance.

### ***Our business and growth depend substantially on customers renewing their agreements with us and expanding their use of our solution for additional available markets. Any decline in our customer renewals or failure to expand their relationships with us could harm our future operating results.***

In order for us to improve our operating results and grow, it is important that our customers renew their agreements with us when the initial contract term expires and that we expand our customer relationships to add new market opportunities and related service revenue opportunity under management. Our customers may elect not to renew their contracts with us after the initial terms have expired, and we cannot assure you that our customers will renew service contracts with us at the same or higher level of service, if at all, or provide us with the opportunity to manage additional opportunity. Although our renewal rates have been historically higher than those achieved by our customers prior to their using our solution, some customers have elected not to renew their agreements with us. Our customers' renewal rates may decline or fluctuate as a result of a number of factors, including their satisfaction or dissatisfaction with our solution and results, our pricing, mergers and acquisitions affecting our customers or their end customers, the effects of economic conditions or reductions in our customers' or their end customers' spending levels. If our customers do not renew their agreements with us, renew on less favorable terms or fail to contract with us for additional service revenue management opportunities, our revenue may decline and we may not realize improved operating results and growth from our customer base.

### ***A substantial portion of our business consists of supporting our customers' channel partners in the sale of service contracts. If those channel partners become unreceptive to our solution, our business could be harmed.***

Many of our customers, including some of our largest customers, sell service contracts through their channel partners and engage our solution to help those channel partners become more effective at selling service contract renewals. These channel partners may have access to some of our cloud applications, such as our Channel Sales Cloud, in addition to other sales support services we provide. In this context, the ultimate buyers of the service contracts are end customers of those channel partners, who then receive the actual services from our customers. In the event our customers' channel partners become unreceptive to our involvement in the renewals process, those channel partners could discourage our current

or future customers from engaging our solution to support channel sales. This risk is compounded by the fact that large channel partners may have relationships with more than one of our customers or prospects, in which case the negative reaction of one or more of those

## **Table of Contents**

large channel partners could impact multiple customer relationships. Accordingly, with respect to those customers and prospective customers who sell service contracts through channel partners, any significant resistance to our solution by their channel partners could harm our ability to attract or retain customers, which would damage our overall business operations.

***We face long sales cycles to secure new customer contracts, making it difficult to predict the timing of specific new customer relationships.***

We face a variable selling cycle to secure new customer agreements, typically spanning a number of months and requiring our effort to obtain and analyze our prospect's business through the SPA, for which we are not paid. We recently have also experienced a lengthening of our sales cycles reflecting the hiring of a number of new sales personnel in the past eighteen months who are new to selling our solution as well as slower decision making by a few end customers as well as other end customers considering renewals of large, multi-year contracts. This has adversely affected the conversion rates of new customer contracts. Moreover, even if we succeed in developing a relationship with a potential new customer, the scope of the potential subscription or service revenue management engagement frequently changes over the course of the business discussions and, for a variety of reasons, our sales discussions may fail to result in new customer acquisitions. Consequently, we have only a limited ability to predict the timing and size of specific new customer relationships.

***If we experience significant fluctuations in our anticipated growth rate and fail to balance our expenses with our revenue forecasts, our results could be harmed.***

Due to our evolving business model, the uncertain size of our markets and the unpredictability of future general economic and financial market conditions, we may not be able to accurately forecast our growth rate. We plan our expense levels and investments based on estimates of future sales performance for our customers with respect to their end customers, future revenue and future customer acquisition. If our assumptions prove incorrect, we may not be able to adjust our spending quickly enough to offset the resulting decline in growth and revenue. Consequently, we expect that our gross margins, operating margins and cash flows may fluctuate significantly on a quarterly basis.

***If we cannot efficiently implement our offering for customers, we may be delayed in generating revenue, fail to generate revenue and/or incur significant costs.***

In general, our customer engagements are complex and may require lengthy and significant work to implement our offerings. We also have limited experience implementing our Renew OnDemand platform. As a result, we generally incur sales and marketing expenses related to the commissions owed to our sales representatives and make upfront investments in technology and personnel to support the engagements one to three months before we begin selling end customer contracts. Each customer's situation may be different, and unanticipated difficulties and delays may arise as a result of our failure, or that of our customer, to meet respective implementation responsibilities. If the customer implementation process is not executed successfully or if execution is delayed, we could incur significant costs without yet generating revenue, and our relationships with some of our customers may be adversely impacted.

***Because competition for our target employees is intense, we may be unable to attract and retain the highly skilled employees we need to support our planned growth.***

To continue to execute on our growth plan, we must attract and retain highly qualified sales representatives, engineers and other key employees in the international markets in which we have operations. Competition for these personnel is intense, especially for highly educated, qualified sales representatives. We have from time to time in the past experienced, and we expect to continue to experience in the future, difficulty in hiring and retaining highly skilled key employees with appropriate qualifications. If we fail to attract new sales representatives, engineers and other key employees, or fail to retain and motivate our most successful employees, our business and future growth prospects could be harmed.

***The length of time it takes our newly-hired sales representatives to become productive could adversely impact our success rate, the execution of our overall business plan and our costs.***

It can take twelve months or longer before our internal sales representatives are fully trained and productive in selling our solution to prospective customers. This long ramp period presents a number of operational challenges as the cost of recruiting, hiring and carrying new sales representatives cannot be offset by the revenue such new sales representatives produce until after they complete their long ramp periods. Further, given the length of the ramp period, we often cannot determine if a sales representative will succeed until he or she has been employed for a year or more. If we cannot reliably develop our sales representatives to a productive level, or if we lose productive representatives in whom we have heavily invested, our future growth rates and revenue will suffer.



## **Table of Contents**

*If we lose our top executives, or if we are unable to attract, hire, integrate and retain key personnel and other necessary employees, our business will be harmed.*

Our future success depends on the continued contributions of our executives, each of whom may be difficult to replace. Our future success also depends in part on our ability to attract, hire, integrate and retain qualified service sales personnel, sales representatives and management-level employees to oversee such sales forces in addition to marketing, research and development and general and administrative personnel to support our global operation. In particular, Michael Smerklo, our chairman of the board of directors and chief executive officer, is critical to the management of our business and operations and the development of our strategic direction. The loss of Mr. Smerklo's services or those of our other executives, or our inability to continue to attract and retain high-quality talent, could harm our business.

*We depend on revenue from sources outside the United States, and our international business operations and expansion plans are subject to risks related to international operations, and may not increase our revenue growth or enhance our business operations.*

For the three months ended March 31, 2013, approximately 38% of our revenue was generated from sales centers located outside of the United States. As a result of our continued focus on international markets, we expect that future revenue derived from international sources will continue to represent a significant portion of our total revenue.

A portion of the sales commissions earned from our international customers is paid in foreign currencies. As a result, fluctuations in the value of these foreign currencies may make our solution more expensive or cause resulting fluctuations in cost for international customers, which could harm our business. We currently do not undertake hedging activities to manage these currency fluctuations. In addition, if the effective price of the contracts we sell to the end customers were to increase as a result of fluctuations in the exchange rate of the relevant currencies, demand for such contracts could fall, which in turn would reduce our revenue.

Our growth strategy includes further expansion into international markets. Our international expansion may require significant additional financial resources and management attention, and could negatively affect our financial condition, cash flows and operating results. In addition, we may be exposed to associated risks and challenges, including:

the need to localize and adapt our solution for specific countries, including translation into foreign languages and associated expenses;

difficulties in staffing and managing foreign operations;

different pricing environments, longer sales cycles and longer accounts receivable payment cycles and difficulties in collecting accounts receivable;

new and different sources of competition;

weaker protection for our intellectual property than in the United States and practical difficulties in enforcing our rights abroad;

laws and business practices favoring local competitors;

compliance obligations related to multiple, conflicting and changing foreign governmental laws and regulations, including employment, tax, privacy and data protection laws and regulations;

increased financial accounting and reporting burdens and complexities;

restrictions on the transfer of funds;

adverse tax consequences; and

unstable regional economic and political conditions.

We cannot assure you we will succeed in creating additional international demand for our solution or that we will be able to effectively sell service agreements in all of the international markets we enter.

***We incur increased costs and demands upon management as a result of complying with the laws and regulations affecting public companies, which could adversely affect our operating results.***

As a public company, we incur significant legal, accounting and other expenses, and greater expenditures may be necessary in the future with the advent of new laws, regulations and stock exchange listing requirements pertaining to public companies. The Sarbanes-Oxley Act of 2002 and the Dodd-Frank Act of 2010, as well as rules subsequently implemented by the Securities and Exchange Commission and The NASDAQ Stock Market LLC, impose various requirements on public companies, including establishing effective internal controls and certain corporate governance practices. Our management and other personnel devote a substantial amount of time to these compliance initiatives, and additional laws and regulations may

## **Table of Contents**

divert further management resources. Moreover, if we are not able to meet new compliance requirements in a timely manner, the market price of our stock could decline, and we could be subject to investigations and other actions by The NASDAQ Stock Market LLC, the Securities and Exchange Commission, or other regulatory authorities, which would require additional financial and management resources.

***While we believe we currently have adequate internal control over financial reporting, we are required to evaluate our internal control over financial reporting under Section 404 of the Sarbanes-Oxley Act of 2002 and any adverse results from such evaluation could result in a loss of investor confidence in our financial reports and have an adverse effect on our stock price.***

Under Section 404 of the Sarbanes-Oxley Act, we are required to furnish a report by our management on our internal control over financial reporting. The report contains, among other matters, an assessment of the effectiveness of our internal control over financial reporting as of the end of our fiscal year, including a statement as to whether or not our internal control over financial reporting is effective. This assessment must include disclosure of any material weaknesses in our internal control over financial reporting identified by management.

We monitor and assess our internal control over financial reporting, and if our management identifies one or more material weaknesses in our internal control over financial reporting and such weakness remains uncorrected at year-end, we will be unable to assert such internal control is effective at such time. If we are unable to assert that our internal control over financial reporting is effective at year-end (or if our independent registered public accounting firm is unable to express an opinion on the effectiveness of our internal controls or concludes that we have a material weakness in our internal controls), we could lose investor confidence in the accuracy and completeness of our financial reports, which would likely have an adverse effect on our business and stock price.

***Changes in the U.S. and foreign legal and regulatory environment that affect our operations, including those relating to privacy, data security and cross-border data flows, could pose a significant risk to us by disrupting our business and increasing our expenses.***

We are subject to a wide variety of laws and regulations in the United States and the other jurisdictions in which we operate, and changes in the level of government regulation of our business have the potential to materially alter our business practices with resultant increases in costs and decreases in profitability. Depending on the jurisdiction, those changes may come about through new legislation, the issuance of new regulations or changes in the interpretation of existing laws and regulations by a court, regulatory body or governmental official. Sometimes those changes may have both prospective and retroactive effect, which is particularly true when a change is made through reinterpretation of laws or regulations that have been in effect for some time.

Privacy and data security are rapidly evolving areas of regulation, and additional regulation in those areas, some of it potentially difficult and costly for us to accommodate, is frequently proposed and occasionally adopted. Laws in many countries and jurisdictions, particularly in the European Union and Canada, govern the requirements related to how we store, transfer or otherwise process the private data provided to us by our customers. In addition, the centralized nature of our information systems at the data and operations centers that we use requires the routine flow of data relating to our customers and their respective end customers across national borders, both with respect to the jurisdictions within which we have operations and the jurisdictions in which we provide services to our customers. If this flow of data becomes subject to new or different restrictions, our ability to serve our customers and their respective customers could be seriously impaired for an extended period of time. For example, we participate in the U.S. Department of Commerce Safe Harbor Framework to govern our treatment of data and data flow with respect to our customers and their respective customers across various jurisdictions. We also have entered into various model contracts and related contractual provisions to enable these data flows. For any jurisdictions in which these measures are not recognized or otherwise not compliant with the laws of the countries in which we process data, or where more stringent data privacy laws are enacted irrespective of international treaty arrangements or other existing compliance mechanisms, we could face increased compliance expenses and face penalties for violating such laws or be excluded from those markets altogether, in which case our operations could be materially damaged.

***If we do not adequately protect our intellectual property rights, our competitive position and our business may suffer.***

We rely upon a combination of patent, trademark, copyright and trade secret law and contractual terms to protect our intellectual property rights, all of which provide only limited protection. Our success depends, in part, upon our ability to establish, protect and enforce our intellectual property and other proprietary rights. If we fail to protect or effectively enforce our intellectual property rights, others may be able to compete against us using intellectual property that is the same as or similar to our own. In addition, we cannot assure you that our intellectual property rights are sufficient to provide us with a competitive advantage against others who offer services similar to ours.



## **Table of Contents**

While we have filed patent applications to protect our intellectual property, we cannot assure you that any issued patents arising from our applications will provide the protection we seek, or that any future patents issued to us will not be challenged, invalidated or circumvented. Also, we cannot assure you that we will obtain any copyright or trademark registrations from our pending or future applications or that any of our trademarks will be enforceable or provide adequate protection of our proprietary rights. We also rely in some circumstances on trade secrets to protect our technology. Trade secrets may lose their value if not properly protected. We endeavor to enter into non-disclosure agreements with our employees, customers, contractors and business partners to limit access to and disclosure of our proprietary information. The steps we have taken, however, may not prevent unauthorized use of our technology, and adequate remedies may not be available in the event of unauthorized use or disclosure of our trade secrets and proprietary technology. However, trade secret protection does not prevent others from reverse engineering or independently developing similar technologies. In addition, reverse engineering, unauthorized copying or other misappropriation of our trade secrets could enable third parties to benefit from our technology without paying for it.

Accordingly, despite our efforts, we may be unable to prevent third parties from infringing or misappropriating our intellectual property and using our technology for their competitive advantage. Any such infringement or misappropriation could have a material adverse effect on our business, results of operations and financial condition. Monitoring infringement of our intellectual property rights can be difficult and costly, and enforcement of our intellectual property rights may require us to bring legal actions against infringers. Infringement actions are inherently uncertain and therefore may not be successful, even when claims are meritorious. Even if such actions are successful, they may require a substantial amount of resources and divert our management's attention.

***Claims by others that we infringe or violate their intellectual property could force us to incur significant costs and require us to change the way we conduct our business.***

Numerous technology companies including potential competitors protect their intellectual property rights by means such as patents, trade secrets, copyrights and trademarks. We have not conducted an independent review of patents issued to third parties. Additionally, because patent applications in the United States and many other jurisdictions are kept confidential for some period of time before they are published, we may be unaware of pending patent applications that relate to our proprietary technology. From time to time we may receive letters from other parties alleging, or inquiring about, possible breaches of their intellectual property rights.

Any party asserting that we infringe its proprietary rights would force us to defend ourselves, and possibly our customers, against the alleged infringement. The technology industry is characterized by the existence of a large number of patents, copyrights, trademarks and trade secrets and by frequent litigation based on allegations of infringement or other violations of intellectual property rights. Moreover, the risk of such a lawsuit will likely increase as we become larger, the scope of our solution and technology expands and the number of competitors in our market increases. Any such claims or litigation could:

be time-consuming and expensive to defend, and deplete our financial resources, whether meritorious or not;

require us to stop providing the services that use the technology that infringes the other party's intellectual property;

divert the attention of our technical and managerial resources away from our business;

require us to enter into royalty or licensing agreements with third parties, which may not be available on terms that we deem acceptable, if at all;

prevent us from operating all or a portion of our business or force us to redesign our technology, which could be difficult and expensive and may make the performance or value of our solution less attractive;

subject us to significant liability for damages or result in significant settlement payments; or

## Edgar Filing: SERVICESOURCE INTERNATIONAL, INC. - Form 10-Q

require us to indemnify our customers as we are required by contract to indemnify some of our customers for certain claims based upon the infringement or alleged infringement of any third party's intellectual property rights resulting from our customers' use of our intellectual property.

During the course of any intellectual property litigation, confidential information may be disclosed in the form of documents or testimony in connection with discovery requests, depositions or trial testimony. Disclosure of our confidential information and our involvement in intellectual property litigation could harm us. In addition, any uncertainties resulting from the initiation and continuation of any litigation could significantly limit our ability to continue our operations and could harm our relationships with current and prospective customers. Any of the foregoing could disrupt our business and have a material adverse effect on our operating results and financial condition.

In addition, we may incorporate open source software into our technology solution. The terms of many open source licenses have not been interpreted by United States or foreign courts, and there is a risk that such licenses could be construed in

---

**Table of Contents**

a manner that imposes unanticipated conditions or restrictions on our commercialization of any of our solutions that may include open source software. As a result, we will be required to analyze and monitor our use of open source software closely. As a result of the use of open source software, we could be required to seek licenses from third parties in order to develop such future products, re-engineer our products, discontinue sales of our solutions or release our software code under the terms of an open source license to the public. Given the nature of open source software, there is also a risk that third parties may assert copyright and other intellectual property infringement claims against us based on any use of such open source software, as more generally discussed with respect to general intellectual property claims.

***Various risks could affect our worldwide operations, including numerous events outside of our control, exposing us to significant costs that could adversely affect our operations and customer confidence.***

We conduct operations throughout the world, including our headquarters in the United States and operations in Ireland, Malaysia, Singapore and the United Kingdom. Such worldwide operations expose us to potential operational disruptions and costs as a result of a wide variety of events, including local inflation or economic downturn, currency exchange fluctuations, political turmoil, labor issues, terrorism, natural disasters and pandemics. Any such disruptions or costs could have a negative effect on our ability to provide our solution or meet our contractual obligations, the cost of our solution, customer satisfaction, our ability to attract or maintain customers, and, ultimately, our profits.

Natural disasters or other catastrophic events may cause damage or disruption to our operations, international commerce and the global economy, and thus could have a strong negative effect on us. Our business operations are subject to interruption by natural disasters, fire, power shortages, pandemics and other events beyond our control. Such events could make it difficult or impossible for us to deliver our solution to our customers, and could decrease demand for our solution. The majority of our research and development activities, corporate headquarters, information technology systems and other critical business operations are located near major seismic faults in the San Francisco Bay Area. Because we may not have insurance coverage that would cover quake-related losses, and significant recovery time could be required to resume operations, our financial condition and operating results could be materially adversely affected in the event of a major earthquake or catastrophic event.

Terrorist attacks and other acts of violence or war may adversely affect worldwide financial markets and could potentially lead to economic recession, which could adversely affect our business, results of operations, financial condition and cash flows. These events could adversely affect our customers' levels of business activity and precipitate sudden significant changes in regional and global economic conditions and cycles.

***The technology we currently use may not operate properly, which could damage our reputation, give rise to claims against us or divert application of our resources from other purposes, any of which could harm our business and operating results.***

The technology we currently use, which includes our Renew OnDemand platform, may contain or develop unexpected defects or errors. There can be no assurance that performance problems or defects in our technology will not arise in the future. Errors may result from receipt, entry or interpretation of customer or end customer information or from the interface of our technology with legacy systems and data that are outside of our control. Despite testing, defects or errors may arise in our solution. Any defects and errors that we discover in our technology and any failure by us to identify and effectively address them could result in loss of revenue or market share, liability to customers or others, failure to achieve market acceptance or expansion, diversion of development resources, injury to our reputation, and increased costs. Defects or errors in our technology may discourage existing or potential customers from contracting with us. Correction of defects or errors could prove impossible or impracticable. The costs incurred in correcting any defects or errors or in responding to resulting claims or liability may be substantial and could adversely affect our operating results.

***Disruptions in service or damage to the data center that hosts our data and our locations could adversely affect our business.***

Our operations depend on our ability to maintain and protect our data servers and cloud applications, which are located in data centers operated for us by third parties. We cannot control or assure the continued or uninterrupted availability of these third-party data centers. In addition, our information technologies and systems, as well as our data center, are vulnerable to damage or interruption from various causes, including natural disasters, war and acts of terrorism and power losses, computer systems failures, Internet and telecommunications or data network failures, operator error, losses of and corruption of data and similar events. Although we conduct business continuity planning and maintain certain insurance for certain events, the situations for which we plan, and the amount of insurance coverage we maintain, may prove inadequate in any particular case. In addition, the occurrence of any of these events could result in interruptions, delays or cessations in the delivery of the solutions we offer to our customers. Any of these events could impair or prohibit our ability to provide our solution, reduce the attractiveness of our solution to current or potential customers and adversely impact our financial condition and results of operations.



## **Table of Contents**

In addition, despite the implementation of security measures, our infrastructure, data centers, operations and other centers or systems that we interface with, including the Internet and related systems, may be vulnerable to physical intrusions, hackers, improper employee or contractor access, computer viruses, programming errors, denial-of-service attacks or other attacks by third parties.

*Any failure or interruptions in the Internet infrastructure, bandwidth providers, data center providers, other third parties or our own systems for providing our solution to customers could negatively impact our business.*

Our ability to deliver our solution is dependent on the development and maintenance of the infrastructure of the Internet and other telecommunications services by third parties. Such services include maintenance of a reliable network backbone with the necessary speed, data capacity and security for providing reliable Internet access and services and reliable telecommunications systems that connect our global operations. While our solution is designed to operate without interruption, we have experienced and expect that we will in the future experience interruptions and delays in services and availability from time to time. We rely on internal systems as well as third-party vendors, including data center, bandwidth, and telecommunications equipment providers, to provide our solution. We do not maintain redundant systems or facilities for some of these services. In the event of a catastrophic event with respect to one or more of these systems or facilities, we may experience an extended period of system unavailability, which could negatively impact our relationship with our customers.

*Additional government regulations may reduce the size of the market for our solution, harm demand for our solution and increase our costs of doing business.*

Any changes in government regulations that impact our customers or their end customers could have a harmful effect on our business by reducing the size of our addressable market or otherwise increasing our costs. For example, with respect to our technology-enabled healthcare and life sciences customers, any change in U.S. Food and Drug Administration or foreign equivalent regulation of, or denial, withholding or withdrawal of approval of, our customers' products could lead to a lack of demand for service revenue management with respect to such products. Other changes in government regulations, in areas such as privacy, export compliance or anti-bribery statutes, such as the U.S. Foreign Corrupt Practices Act, could require us to implement changes in our services or operations that increase our cost of doing business and thereby hurt our financial performance.

The future success of our business depends upon the continued use of the Internet as a primary medium for commerce, communication and business applications. Federal, state or foreign government bodies or agencies have in the past adopted, and may in the future adopt, laws or regulations affecting data privacy and the use of the Internet as a commercial medium. In addition, government agencies or private organizations may begin to impose taxes, fees or other charges for accessing the Internet. These laws or charges could limit the growth of Internet-related commerce or communications generally, result in a decline in the use of the Internet and the viability of Internet-based applications such as ours and reduce the demand for our solution.

*We operate and offer our services in many jurisdictions and, therefore, may be subject to state, local and foreign taxes that could harm our business.*

We operate service sales centers in multiple locations. Some of the jurisdictions in which we operate, such as Ireland, give us the benefit of either relatively low tax rates, tax holidays or government grants, in each case, that are dependent on how we operate or how many jobs we create and employees we retain. We plan on utilizing such tax incentives in the future as opportunities are made available to us. Any failure on our part to operate in conformity with applicable requirements to remain qualified for any such tax incentives or grants may result in an increase in our taxes. In addition, jurisdictions may choose to increase rates at any time due to economic or other factors, such as the current economic situation in Ireland. Any such rate increases may harm our results of operations.

In addition, we may lose sales or incur significant costs should various tax jurisdictions impose taxes on either a broader range of services or services that we have performed in the past. We may be subject to audits of the taxing authorities in the jurisdictions where we do business that would require us to incur costs in responding to such audits. Imposition of such taxes on our services could result in substantial unplanned costs, would effectively increase the cost of such services to our customers and may adversely affect our ability to retain existing customers or to gain new customers in the areas in which such taxes are imposed.

**Table of Contents**

*If we acquire companies or technologies in the future, they could prove difficult to integrate, disrupt our business, dilute stockholder value and adversely affect our operating results and the value of our common stock.*

As part of our business strategy, we may acquire, enter into joint ventures with, or make investments in companies, services and technologies that we believe to be complementary. Acquisitions and investments involve numerous risks, including:

difficulties in identifying and acquiring technologies or businesses that will help our business;

difficulties in integrating operations, technologies, services and personnel;

diversion of financial and managerial resources from existing operations;

the risk of entering new markets in which we have little to no experience;

risks related to the assumption of known and unknown liabilities;

potential litigation by third parties, such as claims related to intellectual property or other assets acquired or liabilities assumed;

the risk of write-offs of goodwill and other intangible assets;

delays in customer engagements due to uncertainty and the inability to maintain relationships with customers of the acquired businesses;

inability to generate sufficient revenue to offset acquisition or investment costs;

incurrence of acquisition-related costs;

harm to our existing business relationships with business partners and customers as a result of the acquisition;

the key personnel of the acquired entity or business may decide not to work for us or may not perform according to our expectations; and

use of substantial portions of our available cash or dilutive issuances of equity securities or the incurrence of debt to consummate the acquisition.

As a result, if we fail to properly evaluate acquisitions or investments, we may not achieve the anticipated benefits of any such acquisitions, we may incur costs in excess of what we anticipate and management resources and attention may be diverted from other necessary or valuable activities.

*We may be exposed to various risks related to legal proceedings or claims that could adversely affect our operating results.*

From time to time, we may be party to lawsuits in the normal course of its business. Litigation in general can be expensive, lengthy and disruptive to normal business operations. Moreover, the results of complex legal proceedings are difficult to predict. Responding to lawsuits brought against us, or legal actions initiated by us, can often be expensive and time-consuming. Unfavorable outcomes from any claims and/or lawsuits could adversely affect our business, results of operations, or financial condition, and we could incur substantial monetary liability and/or be required to change its business practices.

### **Risks Relating to Owning Our Common Stock**

*Our share price has been volatile and is likely to be volatile in the future.*

The trading price of our common stock is likely to be highly volatile and could be subject to wide fluctuations in response to various factors. Further, our common stock has a limited trading history. In addition to the risks described in this section, factors that may cause the market price of our common stock to fluctuate include:

fluctuations in our quarterly financial results or the quarterly financial results of companies perceived to be similar to us as discussed in more detail elsewhere in these Risk Factors;

failure to achieve our revenue or earnings expectations, or those of investors or analysts;

changes in estimates of our financial results or recommendations by securities analysts;

recruitment or departure of key personnel;

investors' general perception of us;

volatility inherent in prices of technology company stocks;

adverse publicity;

the volume of trading in our common stock, including sales upon exercise of outstanding options;

sales of shares of our common stock by existing stockholders;

regulatory developments in our target markets affecting us, our customers or our competitors;

## **Table of Contents**

terrorist attacks or natural disasters or other such events impacting countries where we or our customers have operations; and

actual or perceived changes in general economic, industry and market conditions.

In addition, if the stock market in general experiences a loss of investor confidence, the trading price of our common stock could decline for reasons unrelated to our business, financial condition or results of operations.

Some companies that have had volatile market prices for their securities have had securities class actions filed against them. If a suit were filed against us, regardless of its merits or outcome, it would likely result in substantial costs and divert management's attention and resources. This could have a material adverse effect on our business, operating results and financial condition.

### ***Our actual results may differ significantly from any guidance that we may issue in the future.***

From time to time, we may release financial guidance or other forward looking statements in our earnings releases, earnings conference calls or otherwise, regarding our future performance that represent our management's estimates as of the date of release. If given, this guidance will be based on forecasts prepared by our management. These forecasts are not prepared with a view toward compliance with published accounting guidelines, and neither our independent registered public accounting firm nor any other independent expert or outside party compiles or examines the forecasts and, accordingly, no such person expresses any opinion or any other form of assurance with respect to such forecasts. The principal reason that we may release guidance is to provide a basis for our management to discuss our business outlook with analysts and investors. We do not accept any responsibility for any projections or reports published by any such third persons. Guidance is necessarily speculative in nature, and it can be expected that some or all of the assumptions of any future guidance furnished by us may not materialize or may vary significantly from actual future results.

### ***Concentration of ownership among our existing executive officers, directors and their affiliates may prevent new investors from influencing significant corporate decisions.***

Our directors and executive officers and their affiliates beneficially own, in the aggregate, over 10% of our outstanding common stock as of March 31, 2013. As a result, these stockholders will have substantially influence over all matters requiring stockholder approval, including the election of directors and approval of significant corporate transactions, such as a merger or other sale of our company or its assets. This concentration of ownership could limit the ability of other stockholders to influence corporate matters and may have the effect of delaying or preventing a third party from acquiring control over us.

### ***Anti-takeover provisions contained in our certificate of incorporation and bylaws, as well as provisions of Delaware law, could impair a takeover attempt.***

Our certificate of incorporation, by laws and Delaware law contain provisions that could have the effect of rendering more difficult or discouraging an acquisition deemed undesirable by our board of directors. Our corporate governance documents include provisions:

authorizing blank check preferred stock, which could be issued by our board of directors without stockholder approval, with voting, liquidation, dividend and other rights superior to our common stock;

classifying our board of directors, staggered into three classes, only one of which is elected at each annual meeting;

limiting the liability of, and providing indemnification to, our directors and officers;

limiting the ability of our stockholders to call and bring business before special meetings and to take action by written consent in lieu of a meeting;



## Edgar Filing: SERVICESOURCE INTERNATIONAL, INC. - Form 10-Q

requiring advance notice of stockholder proposals for business to be conducted at meetings of our stockholders and for nominations of candidates for election to our board of directors;

controlling the procedures for the conduct and scheduling of stockholder meetings;

providing the board of directors with the express power to postpone previously scheduled annual meetings and to cancel previously scheduled special meetings;

limiting the determination of the number of directors on our board and the filling of vacancies or newly created seats on the board to our board of directors then in office; and

providing that directors may be removed by stockholders only for cause.

These provisions, alone or together, could delay hostile takeovers and changes in control or changes in our management.

## **Table of Contents**

As a Delaware corporation, we are also subject to provisions of Delaware law, including Section 203 of the Delaware General Corporation law, which limits the ability of stockholders owning in excess of 15% of our outstanding common stock to merge or combine with us.

Any provision of our certificate of incorporation, by laws or Delaware law that has the effect of delaying or deterring a change in control could limit the opportunity for our stockholders to receive a premium for their shares of our common stock, and could also affect the price that some investors are willing to pay for our common stock

*If securities or industry analysts do not publish or cease publishing research or reports about us, our business or our market, or if they change their recommendations regarding our stock, our stock price and trading volume could decline.*

The trading market for our common stock will depend in part on the research and reports that securities or industry analysts publish about us or our business. If any of these analysts cease coverage of us, the trading price and trading volume of our stock could be negatively impacted. If analysts downgrade our stock or publish unfavorable research about our business, our stock price would also likely decline.

### **Item 2. *Unregistered Sales of Equity Securities and Use of Proceeds***

None.

### **Item 3. *Default Upon Senior Securities***

None.

### **Item 4. *Mine Safety Disclosures***

None.

### **Item 5. *Other Information***

None

### **Item 6. *Exhibits***

See the Exhibit Index, which follows the signature page to this report.

**Table of Contents**

**SIGNATURES**

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

SERVICESOURCE INTERNATIONAL, INC.

(Registrant)

Date: May 10, 2013

By: /s/ ASHLEY F. JOHNSON  
Ashley F. Johnson  
(Principal Financial Officer and Duly Authorized Officer)

43

**Table of Contents**

**INDEX TO EXHIBITS**

**Exhibit**

| <b>Number</b> | <b>Description of Document</b>   |
|---------------|--|
| 3.1(1)        | Certificate of Incorporation of the Company filed March 24, 2011.  |
| 3.2(1)        | Bylaws of the Company dated March 24, 2011.  |
| 10.1+         | Amended and restated 2011 Employee Stock Purchase Plan and form of agreement thereunder.   |
| 31.1          | Certification of Principal Executive Officer, pursuant to Rule 13a-14(a) and Rule 15d-14(a) of the Securities Exchange Act of 1934, as amended, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.  |
| 31.2          | Certification of Principal Financial Officer, pursuant to Rule 13a-14(a) and Rule 15d-14(a) of the Securities Exchange Act of 1934, as amended, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.  |
| 32.1*         | Certification of Principal Executive Officer, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.  |
| 32.2*         | Certification of Principal Financial Officer, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.  |
| 101           | Interactive data files (XBRL) pursuant to Rule 405 of Regulation S-T: (i) the Condensed Consolidated Balance Sheets as of March 31, 2013 and December 31, 2012, (ii) the Condensed Consolidated Statement of Operations for the three months ended March 31, 2013 and 2012, (iii) the Condensed Consolidated Statements of Comprehensive Income for the three months ended March 31, 2013 and 2012, (iv) the Condensed Consolidated Statements of Cash Flows for the three months ended March 31, 2013 and 2012 and (v) the Notes to Condensed Consolidated Financial Statements. ** |

(1) Incorporated by reference to the Registrant's Form 8-K filed with the Securities and Exchange Commission on April 1, 2011.

+ Indicates a management contract or compensation plan.

\* In accordance with Item 601(b)(32)(ii) of Regulation S-K and SEC Release No. 33-8238 and 34-47986, Final Rule: Management's Reports on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports, the certifications furnished in Exhibits 32.1 and 32.2 hereto are deemed to accompany this Form 10-Q and will not be deemed filed for purposes of Section 18 of the Exchange Act. Such certifications will not be deemed to be incorporated by reference into any filings under the Securities Act or the Exchange Act, except to the extent that the registrant specifically incorporates it by reference.

\*\* XBRL (Extensible Business Reporting Language) information is furnished and not filed herewith, is not a part of a registration statement or prospectus for purposes of sections 11 or 12 of the Securities Act of 1933, is deemed not filed for purposes of section 18 of the Securities Exchange Act of 1934, and otherwise is not subject to liability under these sections.