

EPAM Systems, Inc.
Form 10-Q
May 09, 2012
[Table of Contents](#)

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended March 31, 2012

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: 001-35418

EPAM SYSTEMS, INC.

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(Exact Name of Registrant as Specified in its Charter)

Delaware
(State or other jurisdiction of
incorporation or organization)

223536104
(I.R.S. Employer
Identification No.)

41 University Drive,

Suite 202

Newtown, Pennsylvania 18940

(Address of principal executive offices, including zip code)

267-759-9000

(Registrant's telephone number, including area code)

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

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

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

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

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

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

Title of Each Class
Common Stock, par value \$0.01 per share

Outstanding as of May 8, 2012
42,297,625 shares

Table of Contents

EPAM SYSTEMS, INC.

TABLE OF CONTENTS

<u>PART I. FINANCIAL INFORMATION</u>	3
<u>Item 1. Financial Statements (Unaudited)</u>	3
<u>Condensed Consolidated Balance Sheets as of March 31, 2012 and December 31, 2011</u>	3
<u>Condensed Consolidated Statements of Income and Comprehensive Income for the Three Months Ended March 31, 2012 and 2011</u>	4
<u>Condensed Consolidated Statements of Cash Flows for the Three Months Ended March 31, 2012 and 2011</u>	5
<u>Notes to Condensed Consolidated Financial Statements</u>	6
<u>Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	15
<u>Item 3. Quantitative and Qualitative Disclosures About Market Risk</u>	24
<u>Item 4. Controls and Procedures</u>	25
<u>PART II. OTHER INFORMATION</u>	25
<u>Item 1. Legal Proceedings</u>	25
<u>Item 1A. Risk Factors</u>	25
<u>Item 2. Unregistered Sales of Equity Securities and Use of Proceeds</u>	26
<u>Item 5. Other Information</u>	27
<u>Item 6. Exhibits</u>	27
<u>SIGNATURES</u>	28

Table of Contents**PART I. FINANCIAL INFORMATION****Item 1. Financial Statements (Unaudited)****EPAM SYSTEMS INC. AND SUBSIDIARIES****CONDENSED CONSOLIDATED BALANCE SHEETS**

	As of March 31, 2012	As of December 31, 2011
	(in thousands, except share and per share data)	
Assets		
Current assets		
Cash and cash equivalents	\$ 112,736	\$ 88,796
Accounts receivable, net of allowance of \$1,786 and \$2,250, respectively	54,235	59,472
Unbilled revenues	41,961	24,475
Prepaid and other current assets	10,157	6,436
Deferred tax assets, current	4,016	4,384
Total current assets	223,105	183,563
Property and equipment, net	37,200	35,482
Restricted cash	2,404	2,582
Intangible assets, net	1,111	1,251
Goodwill	8,459	8,169
Deferred tax assets, long-term	1,791	1,875
Other long-term assets	540	2,691
Total assets	\$ 274,610	\$ 235,613
Liabilities		
Current liabilities		
Accounts payable	\$ 4,060	\$ 2,714
Accrued expenses	13,301	24,782
Deferred revenue	5,479	6,949
Due to employees	14,035	8,234
Taxes payable	9,029	8,712
Deferred tax liabilities, current	1,205	1,736
Total current liabilities	47,109	53,127
Taxes payable, long-term	1,211	1,204
Deferred tax liabilities, long-term	283	283
Total liabilities	48,603	54,614
Commitments and contingencies (See Note 8)		
Preferred stock, \$.001 par value; 0 and 5,000,000 authorized at March 31, 2012 and December 31, 2011; 0 and 2,054,935 Series A-1 convertible redeemable preferred stock issued and outstanding at March 31, 2012 and December 31, 2011; \$.001 par value 0 and 945,114 authorized at March 31, 2012 and December 31, 2011, 0 and 384,804 Series A-2 convertible redeemable preferred stock issued and outstanding at March 31, 2012 and December 31, 2011		85,940

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Stockholders equity

Common stock, \$.001 par value; 160,000,000 authorized; 44,016,335 and 18,914,616 shares issued, 42,260,623 and 17,158,904 shares outstanding at March 31, 2012 and December 31, 2011, respectively	42	17
Preferred stock, \$.001 par value; 0 and 290,277 authorized Series A-3 convertible preferred stock issued and outstanding at March 31, 2012 and December 31, 2011, respectively		
Additional paid-in capital	157,232	40,020
Retained earnings	86,607	74,508
Treasury stock	(15,972)	(15,972)
Accumulated other comprehensive loss	(1,902)	(3,514)
Total stockholders equity	226,007	95,059
Total liabilities and stockholders equity	\$ 274,610	\$ 235,613

The accompanying notes are an integral part of the unaudited condensed consolidated financial statements.

Table of Contents**EPAM SYSTEMS INC. AND SUBSIDIARIES****CONDENSED CONSOLIDATED STATEMENTS OF INCOME AND COMPREHENSIVE INCOME****(Unaudited)**

	Three Months Ended March 31,	
	2012	2011
	(in thousands, except per share data)	
Revenues	\$ 94,383	\$ 72,802
Operating expenses:		
Cost of revenues (exclusive of depreciation and amortization)	60,175	45,505
Selling, general and administrative expenses	17,627	13,793
Depreciation and amortization expense	2,211	1,690
Other operating expenses, net	586	2
Income from operations	13,784	11,812
Interest and other income, net	476	187
Foreign exchange gain/ (loss)	80	(134)
Income before provision for income taxes	14,340	11,865
Provision for income taxes	2,241	2,123
Net income	\$ 12,099	\$ 9,742
Comprehensive income (Note 9)	\$ 13,711	\$ 10,993
Accretion of preferred stock	\$	\$ (2,292)
Net income allocated to participating securities	\$ (3,135)	\$ (4,188)
Net income available for common stockholders	\$ 8,964	\$ 3,262
Net income per share of common stock:		
Basic (common)	\$ 0.30	\$ 0.19
Basic (puttable common)	\$	\$ 0.19
Diluted (common)	\$ 0.27	\$ 0.18
Diluted (puttable common)	\$	\$ 0.18
Shares used in calculation of net income per share of common stock:		
Basic (common)	30,197	17,054
Basic (puttable common)		57
Diluted (common)	33,957	19,381
Diluted (puttable common)		57

The accompanying notes are an integral part of the unaudited condensed consolidated financial statements.

Table of Contents**EPAM SYSTEMS INC. AND SUBSIDIARIES****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS****(Unaudited)**

	Three Months Ended March 31,	
	2012	2011
	(in thousands)	
Cash flows from operating activities:		
Net income	\$ 12,099	\$ 9,742
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	2,211	1,690
Bad debt recovery	(374)	(26)
Deferred taxes	(23)	(294)
Stock-based compensation	1,550	714
Non-cash stock charge (Note 2)	640	
Other	(657)	(397)
Change in operating assets and liabilities:		
Accounts receivable	6,368	2,399
Unbilled revenues	(17,151)	(10,639)
Prepaid expenses and other assets	(714)	440
Accounts payable	1,394	(600)
Accrued expenses	(12,057)	(4,877)
Deferred revenue	(1,625)	(983)
Due to employees	5,767	3,711
Taxes payable	(2,173)	(518)
Net cash (used in)/provided by operating activities	(4,745)	362
Cash flows from investing activities:		
Purchases of property and equipment	(3,324)	(6,318)
Payment for construction of building in Minsk	(572)	
Decrease/(increase) in restricted cash and other long-term assets, net	177	(83)
Net cash used in investing activities	(3,719)	(6,401)
Cash flows from financing activities:		
Net proceeds from issuance of common stock in initial public offering	31,171	
Repurchase of common stock	(50)	
Excess tax benefit on stock-based compensation plans	160	
Other	28	
Net cash provided by financing activities	31,309	
Effect of exchange rate changes on cash and cash equivalents	1,095	666
Net increase/ (decrease) in cash and cash equivalents	23,940	(5,373)
Cash and cash equivalents, beginning of period	88,796	54,004

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Cash and cash equivalents, end of period	\$ 112,736	\$ 48,631
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Summary of non-cash investing and financing transactions:

Accretion of Series A-2 convertible redeemable preferred stock was \$0 in 2012 and \$2,292 in 2011.

Total incurred but not paid costs related to stock issue were \$572 in 2012 and \$0 in 2011.

The accompanying notes are an integral part of the unaudited condensed consolidated financial statements.

Table of Contents

EPAM SYSTEMS INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

(US DOLLAR AMOUNTS IN THOUSANDS, EXCEPT PER SHARE DATA)

1. BASIS OF PRESENTATION

The accompanying unaudited interim consolidated financial statements of EPAM Systems, Inc. (the Company or EPAM) have been prepared in accordance with generally accepted accounting principles in the United States and Article 10 of Regulation S-X under the Securities and Exchange Act of 1934, as amended. The accompanying unaudited condensed consolidated financial statements should be read in conjunction with the Company's audited consolidated financial statements (and notes thereto) for the year ended December 31, 2011. In the Company's opinion, all adjustments considered necessary for a fair presentation of the accompanying unaudited condensed consolidated financial statements have been included, and all adjustments are of a normal and recurring nature. Operating results for the interim periods are not necessarily indicative of results that may be expected to occur for the entire year.

Use of Estimates The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions. These estimates and assumptions affect reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the consolidated financial statements, as well as revenues and expenses during the reporting period. The Company bases its estimates and judgments on historical experience, knowledge of current conditions and its beliefs of what could occur in the future, given available information. Actual results could differ from those estimates, and such differences may be material to the financial statements.

Emerging growth company status In April 2012, several weeks after EPAM's initial public offering in February 2012, President Obama signed into law the Jumpstart Our Business Startups Act of 2012 (the JOBS Act). The JOBS Act contains provisions that relax certain requirements for emerging growth companies that otherwise apply to larger public companies. For as long as a company retains emerging growth company status, which may be until the fiscal year-end after the fifth anniversary of its initial public offering, it will not be required to (1) provide an auditor's attestation report on its management's assessment of the effectiveness of its internal control over financial reporting, otherwise required by Section 404(b) of the Sarbanes-Oxley Act of 2002, (2) comply with any new or revised financial accounting standard applicable to public companies until such standard is also applicable to private companies, (3) comply with certain new requirements adopted by the Public Company Accounting Oversight Board, (4) provide certain disclosure regarding executive compensation required of larger public companies or (5) hold shareholder advisory votes on matters relating to executive compensation.

EPAM is classified as an emerging growth company under the JOBS Act, and is eligible to take advantage of the accommodations described above for as long as it retains this status. However, EPAM has elected not to take advantage of the transition period described in (2) above, which is the exemption provided in Section 7(a)(2)(B) of the Securities Act of 1933 and Section 13(a) of the Securities Exchange Act of 1934 (in each case as amended by the JOBS Act) for complying with new or revised financial accounting standards. EPAM will therefore comply with new or revised financial accounting standards to the same extent that a non-emerging growth company is required to comply with such standards.

2. PREFERRED AND COMMON STOCK

On January 19, 2012, the Company effected an 8 to 1 stock split of the Company's common stock, on which date the number of authorized common and preferred stock was increased to 160,000,000 and 40,000,000 shares, respectively. All shares of common stock, options to purchase common stock and per share information presented in the consolidated financial statements have been adjusted to reflect the stock split on a retroactive basis for all periods presented. There was no change in the par value of the Company's common stock. The ratio by which the then outstanding shares of Series A-1 Preferred, Series A-2 Preferred and Series A-3 Preferred Stock were convertible into shares of common stock had been adjusted to reflect the effects of the common stock split, such that each share of preferred stock was convertible into eight shares of common stock.

In February 2012, the Company completed an initial public offering of 6,900,000 shares of its common stock, which included 900,000 shares of common stock sold by the Company pursuant to an over-allotment option granted to the underwriters, which were sold at a price to the public of \$12.00 per share. The offering commenced on February 7, 2012 and closed on February 13, 2012. Of the 6,900,000 shares of common stock sold, the Company issued and sold 2,900,000 shares of common stock and its selling

Table of Contents

stockholders sold 4,000,000 shares of common stock, resulting in gross proceeds to the Company of \$34,800 and \$28,969 in net proceeds after deducting underwriting discounts and commissions of \$2,436 and offering expenses of \$3,395. The Company did not receive any proceeds from the sale of common stock by the selling stockholders.

Upon the closing of the initial public offering, all outstanding Series-A1 and Series-A2 convertible redeemable preferred stock, and Series A3 convertible preferred stock were converted into 21,840,128 shares of common stock, as shown in the table below.

	Conversion Shares
Series A-1 Convertible Redeemable Preferred Stock	16,439,480
Series A-2 Convertible Redeemable Preferred Stock	3,078,432
Series A-3 Convertible Preferred Stock	2,322,216
 Total	 21,840,128

On August 20, 2010, the Company entered into an agreement with Instant Information Inc. to issue shares of common stock to Instant Information Inc. as consideration for the acquisition of the assets of Instant Information Inc, subject to achievement of certain financial milestones or upon the completion of an initial public offering by the Company. 53,336 shares of common stock were issued to Instant Information Inc. upon completion of this offering for an aggregate value of \$640.

3. GOODWILL

Changes in goodwill for the three months ended March 31, 2012 are as follows:

	North America	EU	Russia	Other	Total
Balance as of January 1, 2012					
Goodwill	2,286	2,864	3,019	1,697	9,866
Accumulated impairment losses				(1,697)	(1,697)
	2,286	2,864	3,019		8,169
Effect of net foreign currency exchange rate changes			290		290
Balance as of March 31, 2012					
Goodwill	2,286	2,864	3,309	1,697	10,156
Accumulated impairment losses				(1,697)	(1,697)
	\$ 2,286	\$ 2,864	\$ 3,309		\$ 8,459

The Company values goodwill at fair value on a non-recurring basis. When testing for impairment, the Company first compares the fair value of its reporting units to the recorded values. Valuation methods used to determine fair value are based on the analysis of the discounted future cash flows that a reporting unit is expected to generate (Income Approach). These valuations are considered Level 3 measurements under FASB ASC Topic 820. The Company utilizes estimates to determine the fair value of the reporting units such as future cash flows, growth rates, capital requirements, effective tax rates and projected margins, among other factors. Estimates utilized in the future evaluations of goodwill for impairment could differ from estimates used in the current period calculations. If the carrying amount of the reporting units exceeds its fair value, goodwill is considered potentially impaired and a second step is performed to measure the amount of impairment loss.

4. RESTRICTED CASH

Restricted cash consists of the following:

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	March 31, 2012	December 31, 2011
Security deposits under client contracts	\$ 1,829	\$ 2,082
Deposit under employee loan programs	468	393
Security deposit under operating leases	107	107
Total	\$ 2,404	\$ 2,582

Table of Contents

At March 31, 2012, and December 31, 2011, security deposits under client contracts included fixed amounts placed in respect of letters of credit and a bank guarantee intended to secure appropriate performance under respective contracts. The Company estimates the probability of non-performance under the contracts as remote, therefore, no provision for losses has been created in respect of these amounts as of March 31, 2012, and December 31, 2011.

Included in restricted cash as of March 31, 2012 and December 31, 2011, were deposits of \$468 and \$393, respectively, placed in connection with certain employee loan programs (See Note 8).

5. LONG-TERM DEBT

Revolving Line of Credit In November 2006, the Company entered into a revolving credit loan and security agreement (collectively "Credit Facility" or "Facility") with a bank (the "Bank"). The Credit Facility is comprised of a five year revolving line of credit pursuant to which the Company can borrow up to \$7,000 at any point in time based on borrowing availability, as defined, at LIBOR plus 1.25%. In September 2010, the Company extended the term of the Facility through October 15, 2013. On July 25, 2011, the Company and the Bank agreed to amend the Facility to increase the borrowing capacity to \$30,000. The maximum borrowing availability under the Facility is based upon a percentage of eligible accounts receivable and US cash. As of March 31, 2012 and December 31, 2011, the borrowing availability was \$23,371 and \$30,000, respectively.

The Facility is collateralized by 85% of US trade receivables, as defined, and US cash representing the lesser of (a) available cash on hand, and (b) \$10,000, \$5,000 and \$0 for the periods ended December 31, 2011, 2012 and 2013, respectively. The Facility contains affirmative and negative covenants, including financial and coverage ratios. As of March 31, 2012 and December 31, 2011, the Company had no outstanding borrowing under the facility and was in compliance with all debt covenants as of those dates.

6. INCOME TAXES

The Company's worldwide effective tax rate was 15.6% and 17.9% in the first quarter of 2012 and 2011, respectively. The decrease in the Company's worldwide effective tax rate in the first quarter of 2012 as compared to the same period of 2011 was primarily due to the movement of a portion of the Company's pre-tax income from the United States to countries with lower statutory tax rates such as the United Kingdom, Russia and Belarus; and the reduction in 2012 statutory tax rates in Ukraine, the United Kingdom and, to a lesser extent, in Switzerland.

7. EARNINGS PER SHARE

Basic EPS is computed by dividing the net income applicable to common stockholders for the period by the weighted average number of shares of common stock outstanding during the same period. The Company's Series A-1 Preferred, Series A-2 Preferred, and Series A-3 Preferred Stock, that had been outstanding and convertible into common stock until February 13, 2012, and its puttable common stock were considered participating securities since these securities had non-forfeitable rights to dividends or dividend equivalents during the contractual period and thus required the two-class method of computing EPS. When calculating diluted EPS, the numerator is computed by adding back the undistributed earnings allocated to the participating securities in arriving at the basic EPS and then reallocating such undistributed earnings among the company's common stock, participating securities and the potential common shares that result from the assumed exercise of all dilutive options. The denominator is increased to include the number of additional common shares that would have been outstanding had the options been issued.

No preferred stock was outstanding as of March 31, 2012, as a result of the Company's initial public offering on February 13, 2012 when all convertible preferred stock was converted into common stock.

Table of Contents

The following table sets forth the computation of basic and diluted earnings per share as follows:

	Three Months Ended March 31,	
	2012	2011
	(in thousands, except per share data)	
Numerator for common earnings per share:		
Net income	\$ 12,099	\$ 9,742
Accretion of preferred stock		(2,292)
Net income allocated to participating securities	(3,135)	(4,188)
Numerator for basic (common) earnings per share	8,964	3,262
Effect on income available from reallocation of options	265	236
Numerator for diluted (common) earnings per share	\$ 9,229	\$ 3,498
Numerator for (puttable common) earnings per share:		
Net income allocated to basic (puttable common)		11
Effect on income available from reallocation of options		(1)
Numerator for diluted (puttable common) earnings per share		10
Denominator for basic (common) earnings per share:		
Weighted average common shares outstanding	30,197	17,054
Effect of dilutive securities:		
Stock options	3,760	2,327
Denominator for diluted (common) earnings per share	33,957	19,381
Denominator for basic and diluted (puttable common) earnings per share:		
Weighted average puttable common shares outstanding		57
Earnings per share:		
Basic (common)	\$ 0.30	\$ 0.19
Basic (puttable common)		0.19
Diluted (common)	0.27	0.18
Diluted (puttable common)		0.18
Anti-dilutive options not included in the calculation	1,400	

8. COMMITMENTS AND CONTINGENCIES

Employee Loan Program Beginning in third quarter of 2006, the Company started to guarantee bank loans for certain of its key employees. Under the conditions of the guarantees, the Company is required to maintain a security deposit of 30% of the value of loans outstanding at each reporting date. As of March 31, 2012, the total commitment of the Company under these guarantees was \$715. The Company estimates a probability of material losses under the program as remote, therefore, no provision for losses was recognized for the three months ended March 31, 2012.

9. COMPREHENSIVE INCOME

The components of accumulated other comprehensive income as of March 31, 2012 and December 31, 2011 were as follows:

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	March 31, 2012	December 31, 2011
Foreign currency translation adjustments	\$ (1,902)	\$ (3,514)
Total accumulated other comprehensive income	\$ (1,902)	\$ (3,514)

The components of comprehensive income for the three months ended March 31, 2012 and 2011 were as follows:

	2012	2011
Comprehensive income:		
Net income	\$ 12,099	\$ 9,742
Foreign currency translation adjustments	1,612	1,251
Total comprehensive income	\$ 13,711	\$ 10,993

Table of Contents**10. OPERATING SEGMENTS**

The Company's reportable segments are: North America, Europe, Russia and Other. This determination is based on the unique business practices and market specifics of each region and that each region engages in business activities from which it earns revenues and incurs expenses. The Company's chief operating decision maker evaluates the Company's performance and allocates resources based on segment revenues and operating profit. Segment operating profit is defined as income from operations before unallocated costs. Generally, operating expenses for each operating segment have similar characteristics and are subject to similar factors, pressures and challenges. Expenses included in segment operating profit consist principally of direct selling and delivery costs as well as an allocation of certain shared services expenses. Certain expenses are not specifically allocated to specific segments as management does not believe it is practical to allocate such costs to individual segments because they are not directly attributable to any specific segment. Further, stock based compensation expense is not allocated to individual segments in internal management reports used by the chief operating decision maker. Accordingly, these expenses are separately disclosed as unallocated and adjusted only against the Company's total income from operations.

Revenues from external customers and segment operating profit, before unallocated expenses, for the North America, Europe, Russia and Other reportable segments for the three months ended March 31, 2012 and 2011, were as follows:

	Three Months Ended March 31,	
	2012	2011
Total segment revenues:		
North America	\$ 42,863	\$ 34,166
Europe	39,861	25,202
Russia	9,477	9,996
Other	2,170	3,329
Total segment revenues	\$ 94,371	\$ 72,693
Segment operating profit:		
North America	\$ 9,726	\$ 8,624
Europe	8,660	4,384
Russia	319	1,382
Other	201	296
Total segment operating profit	\$ 18,906	\$ 14,686

Intersegment transactions were excluded from the above on the basis they are neither included into the measure of a segment's profit and loss by the chief operating decision maker, nor provided to the chief operating decision maker on a regular basis.

Reconciliation of segment revenues and operating profit to consolidated income from operations is presented below:

	Three Months Ended March 31,	
	2012	2011
Total segment revenues	\$ 94,371	\$ 72,693
Unallocated revenue	12	109
Revenues	\$ 94,383	\$ 72,802

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	Three Months Ended March 31,	
	2012	2011
Total segment operating profit	\$ 18,906	\$ 14,686
Unallocated amounts:		
Other revenues	12	109
Stock-based compensation expense	(1,550)	(714)
Stock charge (Note 2)	(640)	
Non-corporate taxes	(725)	(580)
Professional fees	(429)	(298)
Depreciation and amortization	(157)	(230)
Bank charges	(249)	(149)
Other corporate expenses	(1,384)	(1,012)
Income from operations	\$ 13,784	\$ 11,812

Table of Contents

Geographic Area Information

Management has determined that it is not practical to allocate identifiable assets by segment since such assets are used interchangeably amongst the segments. Geographical information about the Company's long-lived assets based on physical location of the assets was as follows:

	As of March 31, 2012	As of December 31, 2011
Belarus	\$ 26,512	\$ 26,001
Ukraine	4,789	4,314
Russia	2,254	2,011
United States	1,499	1,445
Hungary	1,577	1,108
Other	569	603
Total	\$ 37,200	\$ 35,482

Long-lived assets include property and equipment, net of accumulated depreciation and amortization.

Information about the Company's revenues by client location was as follows:

	Three Months Ended March 31,	
	2012	2011
United States	\$ 46,039	\$ 37,257
United Kingdom	22,928	13,668
Russia	9,098	9,503
Switzerland	6,145	3,595
Germany	3,482	1,325
Kazakhstan	1,671	1,745
Sweden	1,455	1,298
Netherlands	790	1,242
Other locations		