

SERVICESOURCE INTERNATIONAL, INC.

Form 10-Q

November 09, 2016

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

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2016

OR

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

For the transition period from _____ to _____

Commission file number 001-35108

SERVICESOURCE INTERNATIONAL, INC.

(Exact name of registrant as specified in our charter)

Delaware

No. 81-0578975

(State or Other Jurisdiction of

(I.R.S. Employer

Incorporation or Organization)

Identification No.)

760 Market Street, 4th Floor

94102

San Francisco, California

(Address of Principal Executive Offices) (Zip Code)

(415) 901-6030

(Registrant's Telephone Number, Including Area Code)

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

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

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

Large accelerated filer

Accelerated filer

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

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

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

Class Outstanding as of October 28, 2016

Common Stock 86,934,054

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

SERVICESOURCE INTERNATIONAL, INC.
 CONDENSED CONSOLIDATED BALANCE SHEETS
 (In thousands, except per share amounts)
 (Unaudited)

	September 30, 2016	December 31, 2015
Assets		
Current assets:		
Cash and cash equivalents	\$ 51,695	\$ 72,334
Short-term investments	139,178	136,378
Accounts receivable, net	54,133	56,563
Deferred income taxes	—	97
Prepaid expenses and other	6,128	8,167
Total current assets	251,134	273,539
Property and equipment, net	37,167	25,903
Deferred income taxes, net of current portion	—	1,759
Goodwill and intangibles, net	8,310	9,444
Other assets, net	5,424	6,919
Total assets	\$ 302,035	\$ 317,564
Liabilities and Stockholders' Equity		
Current liabilities:		
Accounts payable	\$ 1,573	\$ 1,067
Accrued taxes	508	1,112
Accrued compensation and benefits	20,587	22,116
Deferred revenue	4,985	5,770
Accrued expenses	6,317	4,716
Other current liabilities	1,707	2,327
Total current liabilities	35,677	37,108
Obligations under capital leases, net of current portion	138	198
Convertible notes, net	132,515	126,051
Other long-term liabilities	6,598	6,232
Total liabilities	174,928	169,589
Commitments and contingencies (Note 8)		
Stockholders' equity:		
Common stock; \$0.0001 par value; 1,000,000 shares authorized; 87,037 shares issued and 86,916 shares outstanding as of September 30, 2016; 86,893 shares issued and 86,772 shares outstanding as of December 31, 2015	8	8
Treasury stock	(441	) (441
Additional paid-in capital	335,355	331,922
Accumulated deficit	(207,862	) (183,941
Accumulated other comprehensive income	47	427
Total stockholders' equity	127,107	147,975
Total liabilities and stockholders' equity	\$ 302,035	\$ 317,564

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

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
Net revenue	\$62,514	\$59,432	\$184,233	\$187,242
Cost of revenue	40,789	42,568	122,568	131,076
Gross profit	21,725	16,864	61,665	56,166
Operating expenses:				
Sales and marketing	8,847	10,667	30,626	31,667
Research and development	1,952	3,474	6,132	12,942
General and administrative	14,638	10,912	38,233	33,778
Restructuring and other	—	(2)	) —	3,737
Total operating expenses	25,437	25,051	74,991	82,124
Loss from operations	(3,712)	(8,187)	) (13,326)	(25,958)
Interest expense and other, net	(2,291)	(2,513)	) (5,499)	(7,097)
Impairment of cost basis equity investment	(2,300)	—	) (2,300)	—
Loss before income taxes	(8,303)	(10,700)	) (21,125)	(33,055)
Income tax provision	968	203	2,505	1,515
Net loss	\$(9,271)	\$(10,903)	\$(23,630)	\$(34,570)
Net loss per share, basic and diluted	\$(0.11)	\$(0.13)	\$(0.27)	\$(0.41)
Weighted average common shares outstanding, basic and diluted	86,283	85,994	85,981	85,113

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

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CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE LOSS

(In thousands)

(Unaudited)

	Three Months		Nine Months Ended	
	Ended September 30,		September 30,	
	2016	2015	2016	2015
Net loss	\$(9,271)	\$(10,903)	\$(23,630)	\$(34,570)
Other comprehensive income (loss), net of tax:				
Foreign currency translation adjustments	(110)	184	(1,229)	289
Unrealized gain (loss) on short-term investments, net of tax	(81)	4	849	118
Other comprehensive income (loss), net of tax	(191)	188	(380)	407
Total comprehensive loss, net of tax	\$(9,462)	\$(10,715)	\$(24,010)	\$(34,163)

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

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

	Nine Months Ended September 30,	
	2016	2015
Cash flows from operating activities		
Net loss	\$(23,630)	\$(34,570)
Adjustments to reconcile net loss to net cash provided by operating activities:		
Depreciation and amortization	11,636	10,204
Amortization of debt discount and issuance costs	6,464	5,955
Accretion of premium on short-term investments and other	888	(205)
Deferred income taxes	1,698	1,155
Stock-based compensation	7,441	10,804
Restructuring and other	—	3,518
Impairment of cost basis equity investment	2,300	—
Changes in operating assets and liabilities:		
Accounts receivable, net	2,778	12,740
Deferred revenue	(805)	(1,043)
Prepaid expenses and other	1,306	(539)
Accounts payable	407	(620)
Accrued taxes	(627)	(879)
Accrued compensation and benefits	(1,509)	(580)
Accrued expenses	1,670	(4,031)
Other liabilities	(311)	(844)
Net cash provided by operating activities	9,706	1,065
Cash flows from investing activities		
Acquisition of property and equipment	(21,203)	(8,273)
Restricted cash	—	(1,244)
Purchases of short-term investments	(86,365)	(73,567)
Sales of short-term investments	83,331	61,430
Maturities of short-term investments	350	690
Net cash used in investing activities	(23,887)	(20,964)
Cash flows from financing activities		
Repayment on capital leases obligations	(120)	(139)
Repurchase of common stock	(8,921)	—
Proceeds from common stock issuances	5,034	3,476
Minimum tax withholding requirement	(770)	(708)
Net cash (used in) provided by financing activities	(4,777)	2,629
Net decrease in cash and cash equivalents	(18,958)	(17,270)
Effect of exchange rate changes on cash and cash equivalents	(1,681)	717
Cash and cash equivalents at beginning of period	72,334	90,382
Cash and cash equivalents at end of period	\$51,695	\$73,829

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

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SERVICESOURCE INTERNATIONAL, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Note 1 — Description of Business and Basis of Presentation

ServiceSource International, Inc. (together with its subsidiaries, the “Company”) is a global leader in customer and revenue lifecycle solutions that power enterprise revenue relationships, partnering with business to business technology and technology-enabled companies to optimize maintenance, support and subscription revenue streams, while also improving end customer relationships and loyalty. The Company delivers these results via dedicated service teams and integral cloud-based technologies, leveraging benchmarks and best-practices derived from its rich database of service and renewal behavior. By integrating managed services, cloud software and data, the Company provides its clients with insights into their end customers' businesses, end-to-end management and optimization of the service-contract renewals process and customer success activities, including data management, quoting, selling and recurring revenue business intelligence. The Company receives commissions from its clients based on renewal sales that the Company generates on their behalf under a pay-for-performance or flat-rate model. In addition, the Company also provides a purpose-built cloud application to maximize the renewal of subscriptions, maintenance and support contracts and receives subscription fees from its clients. The Company’s corporate headquarters is located in San Francisco, California. The Company has additional U.S. offices in Colorado, Tennessee and Washington, and international offices in Bulgaria, Ireland, Japan, Malaysia, the Philippines, Singapore and the United Kingdom.

The accompanying unaudited interim condensed consolidated financial statements (“condensed consolidated financial statements”) include the accounts of ServiceSource International, Inc. and its subsidiaries. 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 and the instructions to Form 10-Q and Article 10 of Regulation S-X, without audit. Accordingly, they do not include all of the information required by U.S. GAAP for annual financial statements. The unaudited condensed consolidated balance sheet as of December 31, 2015 has been derived from the Company's audited annual consolidated financial statements included in our Annual Report on Form 10-K for the year ended December 31, 2015 filed with the Securities and Exchange Commission (“SEC”) on March 8, 2016. 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, 2015, 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 the Company's financial position, operating results, and cash flows for the interim periods presented. Preparation of financial statements in accordance with U.S. GAAP requires management to make estimates and assumptions that affect the amounts reported in the Company’s condensed consolidated financial statements and accompanying notes. Actual results could differ materially from those estimates. Also, the results for the interim periods are not necessarily indicative of results for the entire year.

The Company’s Chief Executive Officer (“CEO”) is its chief operating decision maker. The CEO historically managed the Company as two reportable segments: Managed Services and Cloud and Business Intelligence (“CBI”) based on the discrete financial information available for each segment. However, during the second half of 2015, the Company began implementing a series of actions to emphasize a one-company, single go-to-market strategy for its services offering that resulted in the reorganization of its CBI personnel and sales team delivery structure. The objective of these actions was to more closely integrate and support the Managed Services organization with the Company’s cloud technologies and to eliminate new stand-alone CBI cloud offerings. Further, due to this reorganization and shift to a single go-to-market strategy, discrete cost information was no longer separately available for the former CBI segment. Consequently, beginning in the first quarter of 2016, the CEO manages and allocates resources on a company-wide basis as a single segment that is focused on service offerings which integrate data, processes and cloud technologies.

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Recent Accounting Pronouncements

In May 2014, the Financial Accounting Standard Board ("FASB") issued Accounting Standard Update ("ASU") No. 2014-09, Revenue from Contracts with Customers (Topic 606), which supersedes the revenue recognition requirements in the FASB's Accounting Standards Codification ("ASC") 605, Revenue Recognition. This ASU is based on the principle that revenue is recognized to depict the transfer of goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. The ASU also requires additional disclosure about the nature, amount, timing and uncertainty of revenue and cash flows arising from customer contracts, including significant judgments and changes in judgments and assets recognized from costs incurred to obtain or fulfill a contract. In July 2015, the FASB approved a one year deferral of the effective date to December 15, 2017, and early application would be permitted, but not before the original effective date of December 15, 2016, so the effective date will be the first quarter of fiscal year 2018 using one of two retrospective application methods. The Company is currently evaluating the impact ASU No. 2014-09 will have on its consolidated financial statements.

In April 2015, the FASB issued ASU No. 2015-05, Intangibles - Goodwill and Other - Internal Use Software, which provides guidance to customers about whether a cloud computing arrangement includes a software license. If a cloud computing arrangement includes a software license, the update specifies that the customer should account for the software license element of the arrangement consistent with the acquisition of other software licenses. The update further specifies that the customer should account for a cloud computing arrangement as a service contract if the arrangement does not include a software license. ASU No. 2015-05 is effective for the Company in fiscal year 2016. An entity can elect to adopt the amendments either (1) prospectively to all arrangements entered into or materially modified after the effective date or (2) retrospectively. The Company has historically accounted for its cloud computing arrangements as a service contract. Consequently, adoption of ASU No. 2015-05 had no impact on the Company's consolidated financial statements.

In November 2015, the FASB issued ASU No. 2015-17, Balance Sheet Classification of Deferred Taxes, which requires that deferred tax assets and liabilities to be classified as noncurrent in the consolidated balance sheet. The standard will be effective for financial statements issued for annual periods beginning after December 15, 2016, and interim periods within those annual periods. Early adoption is permitted for financial statements that have not been previously issued. The standard may be applied either prospectively to all deferred tax assets and liabilities or retrospectively to all periods presented. The Company is currently evaluating the impact that adoption of ASU No. 2015-17 will have on its consolidated financial statements.

In February 2016, the FASB issued ASU No. 2016-02 Leases (Topic 842). This standard requires entities that lease assets to recognize on the balance sheet the assets and liabilities for the rights and obligations created by those leases. The standard is effective for fiscal years and the interim periods within those fiscal years beginning after December 15, 2018. The guidance is required to be applied by the modified retrospective transition approach. Early adoption is permitted. The Company is currently evaluating the impact of the adoption of this authoritative guidance on its consolidated financial statements.

In March 2016, the FASB issued ASU 2016-09, Compensation—Stock Compensation (Topic 718). The standard is intended to simplify several areas of accounting for share-based compensation arrangements, including the income tax impact, classification on the statement of cash flows and accounting for award forfeitures. ASU 2016-09 is effective for fiscal years, and interim periods within those years, beginning after December 15, 2016, and early adoption is permitted. The Company early adopted ASU 2016-09 during the third quarter of 2016 on a modified retrospective basis for the income statement impact of forfeitures and income taxes. Accordingly, the Company recognized a cumulative adjustment charge of \$0.3 million to beginning Accumulated Deficit as of January 1, 2016 related to the forfeiture rate methodology change. ASU 2016-09 also requires the presentation of excess tax benefits as an operating

activity (combined with other income tax cash flows) on the statement of cash flows rather than as a financing activity. Adopting this provision of the ASU did not have a material impact on the Company's financial statements. The new guidance also requires the presentation of shares withheld for employee taxes as a financing activity (retrospective change) on the statement of cash flows which resulted in a \$0.8 million and \$0.7 million reclassification from operating activities to financing activities for the nine month period ending September 30, 2016 and 2015, respectively.

Reclassifications

Amounts shown in Other assets, net, on the Consolidated Balance Sheet as of December 31, 2015 have been reclassified to Convertible notes, net, to reflect the current period presentation as a result of the adoption of ASU No. 2015-03, Simplifying the Presentation of Debt Issuance Cost, which requires that debt issuance costs related to a recognized debt liability be presented in the balance sheet as a direct deduction from the carrying amount of that debt liability. See Note 7 - Debt.

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Correction to Condensed Consolidated Balance Sheet as of December 31, 2015

Subsequent to the issuance of the Company's 2015 consolidated financial statements, management determined that its net deferred tax asset valuation allowance was incorrectly computed and recorded for the periods ending December 31, 2012, 2013, 2014 and 2015 and March 31, 2016. This error was due to the incorrect netting of an indefinite-lived deferred tax liability related to tax-deductible goodwill against certain deferred tax assets that the Company believed more likely than not would not be realized. In order to be a source of future taxable income to support realizability of a deferred tax asset, a taxable temporary difference must reverse in a period such that it would result in the realization of the deferred tax asset. Taxable temporary differences related to indefinite-lived intangibles and tax-deductible goodwill are problematic in this regard as, by their nature, they are not predicted to reverse (commonly referred to as naked credits). While such temporary differences would reverse on impairment or sale of the related assets, those events are not anticipated under ASC 740 Income taxes ("ASC 740") for purposes of predicting the reversal of the related taxable temporary difference. As a result, the reversal of taxable temporary differences with respect to indefinite-lived assets and tax-deductible goodwill should not be considered a source of future taxable income when evaluating and calculating a valuation allowance in accordance with ASC 740. The cumulative error beginning in 2012, totaled \$2.2 million at March 31, 2016 and \$2.1 million at December 31, 2015.

In evaluating whether the previously issued financial statements were materially misstated, the Company followed the guidance of ASC 250, Accounting Changes and Error Corrections, SEC Staff Accounting Bulletin ("SAB") Topic 1.M, Assessing Materiality, and SAB Topic 1.N, Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements. The Company concluded that the error was not material to the affected prior periods. However, correction of the entire cumulative error would have been material to that quarter's three and six months results and would have impacted comparisons to prior quarters. As a result, certain amounts presented in the Company's condensed consolidated financial statements have been revised from the amounts previously reported to correct this error as shown in the table below and as included elsewhere in this Quarterly Report on Form 10-Q for the period ended September 30, 2016.

Condensed Consolidated Balance Sheet as of December 31, 2015 (in thousands):

	As Previously Reported	Corrections	As Revised
Other long term liabilities	\$ 4,113	\$ 2,119	\$ 6,232
Total liabilities	167,470	2,119	169,589
Accumulated deficit	(181,822)	(2,119)	(183,941)
Total stockholders' equity	150,094	(2,119)	147,975
Total liabilities and stockholders' equity	317,564	—	317,564

Correction to Condensed Consolidated Statements of Operations, Comprehensive Income (Loss) and Cash Flows for the periods ended September 30, 2015

The Company has restated certain amounts in the condensed consolidated statements of operations and comprehensive income for the three and nine months ended September 30, 2015 and the condensed consolidated statement of cash flows for the nine months ended September 30, 2015 to correct income tax expense related to the valuation allowance calculation error discussed above, so that such adjustment is recorded in the proper period. The Company believes this correction is not material to its previously issued annual and interim consolidated financial statements.

The effects of correcting the valuation allowance calculation error are as follows:

- Additional income tax expense of \$0.1 million and \$0.1 million in the three and nine months ended September 30, 2015, respectively, has been recorded;
- Net loss increases \$0.1 million and \$0.1 million in the three and nine months ended September 30, 2015, respectively; and
- Net loss per share, basic and diluted remain unchanged for the three months ended September 30, 2015 and increases from \$0.40 to \$0.41 for the nine months ended September 30, 2015.

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The following tables summarize the effects of the correction on the Company's condensed consolidated statements of operations for three and nine months ended September 30, 2015 (in thousands):