NETSUITE INC
Form 10-Q
August 06, 2014
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

(Mark one)

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

For the quarterly period ended June 30, 2014

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 001-33870

NetSuite Inc.
(Exact name of registrant as specified in its charter)

Delaware	94-3310471
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
2955 Campus Drive, Suite 100	
San Mateo, California	94403-2511
(Address of principal executive offices)	(Zip Code)

(650) 627-1000
(Registrant's telephone number, including area code)

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). (Check one): Yes S 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 definition of “large accelerated filer", "accelerated filer" and "smaller reporting company” in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filerx 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 x

On July 31, 2014, 76,418,720 shares of the registrant’s Common Stock, $0.01 par value, were issued and outstanding.

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NetSuite Inc.

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PART I – Financial Information

ITEM 1. Financial Statements

NetSuite Inc.
Condensed Consolidated Balance Sheets
(dollars in thousands)
(unaudited)

	June 30, 2014	December 31, 2013
Assets		
Current assets:		
Cash and cash equivalents	$479,191	$451,577
Accounts receivable, net of allowances of $1,498 and $833 as of June 30, 2014 and December 31, 2013, respectively	89,961	86,818
Deferred commissions	39,549	38,187
Other current assets	21,492	22,622
Total current assets	630,193	599,204
Property and equipment, net	51,786	48,183
Deferred commissions, non-current	10,404	8,405
Goodwill	84,042	84,478
Other intangible assets, net	16,408	20,460
Other assets	12,763	11,669
Total assets	$805,596	$772,399
Liabilities and total equity		
Current liabilities:		
Accounts payable	$3,124	$4,838
Deferred revenue	237,929	211,694
Accrued compensation	27,335	24,535
Accrued expenses	20,731	21,721
Other current liabilities (including note payable to related party of $2,713 and $3,054 as of June 30, 2014 and December 31, 2013, respectively)	13,530	16,776
Total current liabilities	302,649	279,564
Long-term liabilities:		
Convertible 0.25% senior notes, net	259,758	254,038
Deferred revenue, non-current	14,257	12,913
Other long-term liabilities (including note payable to related party of $7,330 and $8,702 as of June 30, 2014 and December 31, 2013, respectively)	14,733	15,832
Total long-term liabilities	288,748	282,783
Total liabilities	591,397	562,347
Commitments and contingencies (Note 4)		
Total equity:		
Common stock, par value $0.01, 500,000,000 shares authorized; 76,107,175 and 75,131,404 shares issued and outstanding at June 30, 2014 and December 31, 2013, respectively	761	751
Additional paid-in capital	708,178	658,717
Accumulated other comprehensive loss	(173)	(246)
Accumulated deficit	(494,567)	(449,170)
Total equity	214,199	210,052

Total liabilities and total equity	$805,596	$772,399

See accompanying Notes to Condensed Consolidated Financial Statements.

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NetSuite Inc.
Condensed Consolidated Statements of Operations and Comprehensive Loss
(dollars and shares in thousands, except per share data)
(unaudited)

	Six Months Ended June 30,		Three Months Ended June 30,	
	2014	2013	2014	2013
Revenue:				
Subscription and support	$205,246	$154,199	$105,851	$80,239
Professional services and other	49,509	38,426	25,943	20,757
Total revenue	254,755	192,625	131,794	100,996
Cost of revenue:				
Subscription and support	33,444	25,826	17,084	13,511
Professional services and other	46,830	37,225	24,513	19,895
Total cost of revenue	80,274	63,051	41,597	33,406
Gross profit	174,481	129,574	90,197	67,590
Operating expenses:				
Product development	49,548	35,446	25,376	18,796
Sales and marketing	133,406	100,712	69,726	53,960
General and administrative	28,139	25,174	14,106	13,429
Total operating expenses	211,093	161,332	109,208	86,185
Operating loss	(36,612)	(31,758)	(19,011)	(18,595)
Other income / (expense), net:				
Interest income	55	40	36	18
Interest expense	(7,042)	(1,427)	(3,542)	(1,323)
Other expense, net	(309)	(182)	(199)	(39)
Total other income / (expense), net	(7,296)	(1,569)	(3,705)	(1,344)
Loss before income taxes	(43,908)	(33,327)	(22,716)	(19,939)
Provision for income taxes	1,489	100	448	451
Net loss	$(45,397)	$(33,427)	(23,164)	(20,390)
Net loss per common share, basic and diluted	$(0.60)	$(0.45)	$(0.31)	$(0.28)
Weighted average number of shares used in computing net loss per share	75,677	73,547	75,919	73,946
Comprehensive loss:				
Foreign currency translation gains / (loss), net of taxes	(20)	(929)	718	(824)
Accumulated pension liability	93	65	47	32
Comprehensive loss	$(45,324)	$(34,291)	$(22,399)	$(21,182)

See accompanying Notes to Condensed Consolidated Financial Statements.

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NetSuite Inc.
Condensed Consolidated Statements of Cash Flows
(dollars in thousands)
(unaudited)

	Six Months Ended June 30,	
	2014	2013
Cash flows from operating activities:		
Net loss	$(45,397)	$(33,427)
Adjustments to reconcile net loss to net cash provided by operating activities:		
Depreciation and amortization	9,269	7,208
Amortization of other intangible assets	4,050	2,887
Amortization of debt discount and transaction costs	6,332	1,056
Provision for accounts receivable allowances	663	358
Stock-based compensation	43,873	35,266
Amortization of deferred commissions	34,699	25,839
Excess tax benefit on stock-based compensation	(369)	(195)
Changes in operating assets and liabilities, net of acquired assets and assumed liabilities:		
Accounts receivable	(3,760)	2,849
Deferred commissions	(38,060)	(27,098)
Other current assets	1,224	(7,511)
Other assets	(1,720)	(484)
Accounts payable	(1,678)	3,227
Accrued compensation	2,681	(590)
Deferred revenue	27,475	19,595
Other current liabilities	(1,176)	691
Other long-term liabilities	(390)	590
Net cash provided by operating activities	37,716	30,261
Cash flows from investing activities:		
Purchases of property and equipment	(10,326)	(7,131)
Capitalized internal use software	(1,049)	(1,276)
Cash paid in business combination, net of amounts received, and equity investment	—	(33,003)
Net cash used in investing activities	(11,375)	(41,410)
Cash flows from financing activities:		
Proceeds from issuance of convertible 0.25% senior notes	—	310,000
Payments of issuance costs on convertible 0.25% senior notes	—	(7,750)
Payments under capital leases	(155)	(370)
Payments under capital leases and long-term debt - related party	(1,713)	(1,366)
Payments to repurchase common stock	—	(30,000)
Payments related to business combinations	(2,293)	—
RSUs acquired to settle employee withholding liability	(53)	(123)
Excess tax benefit on stock-based compensation	369	195
Proceeds from issuance of common stock	4,668	10,725
Net cash provided by financing activities	823	281,311
Effect of exchange rate changes on cash and cash equivalents	450	(1,126)
Net change in cash and cash equivalents	27,614	269,036
Cash and cash equivalents at beginning of period	451,577	185,859

Cash and cash equivalents at end of period	$479,191	$454,895
Supplemental cash flow disclosure:		
Cash paid for interest to related parties	$250	$157
Cash paid for interest to other parties	$459	$11
Cash paid for income taxes, net of tax refunds	$693	$695
Noncash financing and investing activities:		
Fixed assets acquired under related party agreement	$—	$11,805

See accompanying Notes to Condensed Consolidated Financial Statements.

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NetSuite Inc.
Notes to Condensed Consolidated Financial Statements
(unaudited)

Note 1. Organization
NetSuite Inc. (the “Company”) provides cloud-based financials/Enterprise Resource Planning (“ERP”) and omnichannel commerce software suites. In addition, the Company offers a broad suite of applications, including financial management, Customer Relationship Management (“CRM”), Ecommerce and retail management, Professional Services Automation (“PSA”) and Human Capital Management ("HCM") that enable companies to manage most of their core business operations in its single integrated suite. The Company’s "real-time dashboard" technology provides an easy-to-use view into up-to-date, role-specific business information. The Company also offers customer support and professional services related to implementing and supporting its suite of applications. The Company delivers its suite over the Internet as a subscription service using the software-as-a-service ("SaaS") model. The Company’s headquarters are located in San Mateo, California. The Company conducts its business worldwide, with international locations in Canada, Europe, Asia, Australia and Uruguay.

Note 2. Basis of Presentation

The Condensed Consolidated Financial Statements as of and for the six and three months ended June 30, 2014 included in this Quarterly Report on Form 10-Q have been prepared by the Company, without audit, pursuant to the rules and regulations of the Securities and Exchange Commission (the “SEC”). The condensed consolidated balance sheet data as of December 31, 2013 was derived from the audited consolidated financial statements included in the Company’s Annual Report on Form 10-K for the fiscal year ended December 31, 2013 filed on March 3, 2014. Certain information and footnote disclosures normally included in consolidated financial statements prepared in accordance with generally accepted accounting principles in the United States of America (“GAAP”) have been condensed or omitted pursuant to such rules and regulations. However, the Company believes that the disclosures contained in this Quarterly Report comply with the requirements of Section 13(a) of the Securities Exchange Act of 1934, as amended, for a Quarterly Report on Form 10-Q and are adequate to make the information presented not misleading. These Condensed Consolidated Financial Statements are meant to be, and should be, read in conjunction with the Consolidated Financial Statements and the notes thereto included in the Company’s Annual Report on Form 10-K for the fiscal year ended December 31, 2013 filed on March 3, 2014.

The unaudited Condensed Consolidated Financial Statements included in this Quarterly Report on Form 10-Q reflect all adjustments (which include only normal, recurring adjustments and those items discussed in these Notes) that are, in the opinion of management, necessary to state fairly the financial position and results for the dates and periods presented. The results for such periods are not necessarily indicative of the results to be expected for the full fiscal year.

Recent Accounting Pronouncements

In May 2014, the FASB issued new accounting guidance related to revenue recognition. This new standard will replace most existing U.S. GAAP guidance on this topic. The new revenue recognition standard provides a unified model to determine when and how revenue is recognized. The core principle is that a company should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration for which the entity expects to be entitled in exchange for those goods or services. This guidance will be effective for the Company beginning January 1, 2017 and can be applied either retrospectively to each period presented or as a cumulative-effect adjustment as of the date of adoption. The Company is evaluating the impact of adopting this new accounting standard on its financial statements and has not selected a transition method.

Principles of Consolidation

The consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries. Intercompany balances and transactions have been eliminated.

Use of Estimates

The preparation of financial statements in conformity with GAAP requires management to make certain estimates and assumptions. These estimates and assumptions affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements, as well as reported amounts of revenue and expenses during the reporting period. Actual results could differ from those estimates.

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Revenue Recognition

The Company generates revenue from two sources: (1) subscription and support; and (2) professional services and other. Subscription and support revenue includes subscription fees from customers accessing its on-demand application suite and support fees from customers purchasing support. Arrangements with customers do not provide the customer with the right to take possession of the software supporting the on-demand application service at any time. Professional services and other revenue includes fees generated from training and consulting services such as business process mapping, configuration, data migration and integration. Amounts that have been invoiced are recorded in accounts receivable and in deferred revenue or revenue, depending on whether the revenue recognition criteria have been met. For the most part, subscription and support agreements are entered into for 12 to 36 months. In aggregate, more than 90% of the professional services component of the arrangements with customers is performed within 300 days of entering into a contract with the customer.

The subscription agreements provide service level commitments of 99.5% uptime per period, excluding scheduled maintenance. The failure to meet this level of service availability may require the Company to credit qualifying customers up to the value of an entire month of their subscription and support fees. In light of the Company's historical experience with meeting its service level commitments, the Company has not accrued any liabilities on its balance sheet for these commitments.

The Company commences revenue recognition when all of the following conditions are met:

- There is persuasive evidence of an arrangement;
- The service is being provided to the customer;
- The collection of the fees is reasonably assured; and
- The amount of fees to be paid by the customer is fixed or determinable.

In most instances, revenue from new customer acquisition is generated under sales agreements with multiple elements, comprised of subscription and support fees from customers accessing the Company's on-demand application suite and professional services associated with consultation services. The Company evaluates each element in a multiple-element arrangement to determine whether it represents a separate unit of accounting. An element constitutes a separate unit of accounting when the delivered item has standalone value and delivery of the undelivered element is probable and within the Company's control. Subscription and support have standalone value because they are routinely sold separately by the Company. Professional services have standalone value because the Company has sold professional services separately and there are several third-party vendors that routinely provide similar professional services to its customers on a standalone basis.

The Company allocates revenue to each element in an arrangement based on a selling price hierarchy. The selling price for a deliverable is based on its vendor-specific objective evidence ("VSOE"), if available, third-party evidence ("TPE"), if VSOE is not available, or estimated selling price ("ESP"), if neither VSOE nor TPE is available. As the Company has been unable to establish VSOE or TPE for the elements of its arrangements, the Company establishes the ESP for each element primarily by considering the weighted average of actual sales prices of professional services sold on a standalone basis and subscription and support including various add-on modules when sold together without professional services, and other factors such as gross margin objectives, pricing practices and growth strategy. The consideration allocated to subscription and support is recognized as revenue over the contract period commencing when the subscription service is made available to the customer. The consideration allocated to professional services is recognized as revenue using the proportional performance method.

The total arrangement fee for a multiple element arrangement is allocated based on the relative ESP of each element. However, since the professional services are generally completed prior to completion of delivery of subscription and support services, the revenue recognized for professional services in a given reporting period does not include fees subject to delivery of subscription and support services. This results in the recognition of revenue for professional

services that is generally no greater than the contractual fees for those professional services.

For single element sales agreements, subscription and support revenue is recognized ratably over the contract term beginning on the provisioning date of the contract. The Company recognizes professional services revenue using the proportional performance method for single element arrangements.

Sales and other taxes collected from customers to be remitted to government authorities are excluded from revenues.

Concentration of Credit Risk and Significant Customers

Financial instruments potentially exposing the Company to concentration of credit risk consist primarily of cash and cash equivalents, restricted cash and trade accounts receivable. The Company maintains an allowance for doubtful accounts

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receivable balances. The allowance is based upon historical loss patterns and an evaluation of the potential risk of loss associated with problem accounts. The Company generally charges off the receivable balances of uncollectible accounts when accounts are 120 days past-due based on the account's contractual terms. Credit risk arising from accounts receivable is mitigated due to the large number of customers comprising the Company's customer base and their dispersion across various industries. As of June 30, 2014 and December 31, 2013, there were no customers that represented more than 10% of the net accounts receivable balance. There were no customers that individually exceeded 10% of the Company's revenue in any of the periods presented. As of June 30, 2014 and December 31, 2013, long-lived assets located outside the United States were not significant.

Revenue by geographic region, based on the billing address of the customer, was as follows for the periods presented:

	Six Months Ended June 30,		Three Months Ended June 30,	
	2014	2013	2014	2013
	(dollars in thousands)			
United States	$192,064	$143,702	$100,401	$75,812
International	62,691	48,923	31,393	25,184
Total revenue	$254,755	$192,625	$131,794	$100,996
Percentage of revenue generated outside of the United States	25 %	25 %	24 %	25 %

No single country outside the United States represented more than 10% of revenue during the six months ended June 30, 2014 or 2013.

The Company maintains cash balances at several banks. Accounts located in the United States are insured by the Federal Deposit Insurance Corporation ("FDIC"), up to $250,000. Certain operating cash accounts may exceed the FDIC limits.

Intellectual Property Rights Indemnification

The Company's arrangements include provisions indemnifying customers against liabilities if the Company's products infringe a third-party's intellectual property rights. The Company has not incurred any costs as a result of such indemnifications and has not accrued any liabilities related to such obligations in the accompanying condensed consolidated financial statements.

Qualified Operating Expense Reimbursements

At the Company's product development facility in the Czech Republic, the Company participates in a government subsidy program for employing local residents. Under the program, the Czech government will reimburse the Company for certain operating expenses it incurs. In the period the Company incurs the reimbursable operating expense, it records a reduction in product development expense and a receivable from the Czech government. During the second quarter of 2014, the Company began participating in a second subsidy program, similar in nature to the initial program, as benefits under the initial program reached the program limits in the first quarter of 2014. During the six and three months ended June 30, 2014 , the Company's product development operating expenses were reduced by $864,000 and $257,000, respectively, for reimbursement of eligible operating expenses incurred during those respective time periods. During the six and three months ended June 30, 2013, the Company's product development operating expenses were reduced by $1.2 million and $630,000, respectively, for reimbursement of eligible operating expenses incurred during each respective time period. During the six and three months ended June 30, 2014, the Company received $1.3 million and $673,000, respectively, from the Czech Republic government. As of June 30, 2014, $876,000 in reimbursements, adjusted for foreign currency valuations, are due the Company and included in

other current assets.

Business Combination

On March 6, 2013, the Company completed the purchase of all the outstanding equity of a website hosting provider company ("WH") that specializes in Ecommerce technology and services. On the transaction closing date, the Company paid $10.2 million in cash and withheld consideration of $1.8 million in cash for various periods up to 24 months following the close of the transaction as indemnification against certain losses the Company may incur in the event of certain breaches of representations and warranties in the purchase agreement. During the second quarter of 2014, the Company paid the former

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owners $1.0 million of the withheld consideration and reduced the remaining obligation by approximately $200,000 for various adjustments. As of June 30, 2014, $600,000 in consideration is still being withheld by the Company.

The following table details the Company's goodwill activity during the three months ended June 30, 2014:

	(dollars in thousands)
Balance as of January 1, 2014	$84,478
Business combination adjustments	(163)
Foreign exchange adjustment	(273)
Balance as of June 30, 2014	$84,042

Retail Anywhere

In November 2012, the Company purchased certain assets from Retail Anywhere ("RA"), an on-line retail solution service provider. The Company purchased certain RA assets and assumed certain liabilities to expand its retail software solutions in the Ecommerce vertical. RA software allows the Company to expand its Ecommerce services to brick and mortar store point of sale terminals. The RA assets, liabilities and operating results are reflected in the Company's consolidated financial statements from the date of acquisition. On the closing date, the Company paid $5.0 million in cash. Additional consideration of $1.3 million in cash was being withheld for up to the 15 months following the close of the transaction as protection against certain losses the Company may incur in the event of certain breaches of representations and warranties covered in the purchase agreement. As of December 31, 2013, the Company's remaining obligation was $1.1 million. During the first quarter of 2014, the Company paid $900,000 to the former owners resulting in a remaining obligation of $155,000.

Accumulated Other Comprehensive Loss

Accumulated other comprehensive loss is comprised of foreign currency translation gains and losses, net of tax, and an accumulated pension liability for employees located in the Philippines. There were no significant reclassification adjustments out of accumulated other comprehensive loss to the condensed consolidated statement of operations and comprehensive loss.

Note 3. Financial Instruments

Fair Value Measurements

The Company measures certain financial assets at fair value on a recurring basis based on a fair value hierarchy that requires the Company to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. A financial instrument's categorization within the fair value hierarchy is based upon the lowest level of input that is significant to the fair value measurement. The three levels of inputs that may be used to measure fair value are:

- Level 1 - Quoted prices in active markets for identical assets or liabilities.
- Level 2 - Observable inputs other than Level 1 prices such as quoted prices for similar assets or liabilities; quoted prices in markets with insufficient volume or infrequent transactions (less active markets); or model-derived valuations in which all significant inputs are observable or can be derived principally from or corroborated by observable market data for substantially the full term of the assets or liabilities.
- Level 3 - Unobservable inputs to the valuation methodology that are significant to the measurement of fair value of assets or liabilities.

The fair value of the Company's investments in certain money market funds approximates their face value. Such instruments are classified as Level 1 and are included in cash and cash equivalents.

The fair value of the Company's foreign currency forward contracts is based on foreign currency rates quoted by banks or foreign currency dealers and other public data sources. Such instruments are classified as Level 2 and are included in other current assets and liabilities.

As of June 30, 2014, financial assets stated at fair value on a recurring basis were comprised of money market funds included within cash and cash equivalents and foreign exchange forward contracts included within other current assets and

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liabilities. The fair value of these financial assets was determined using the following inputs as of June 30, 2014 and December 31, 2013:

	June 30, 2014 Fair value measurements at reporting date using				December 31, 2013 Fair value measurements at reporting date using			
	Level 1	Level 2	Level 3	Total	Level 1	Level 2	Level 3	Total
	(in thousands)				(in thousands)			
Assets:								
Money market funds	$252,578	$—	$—	$252,578	$122,527	$—	$—	$122,527
Foreign exchange contracts	—	17	—	17	—	375	—	375
Total	$252,578	$17	$—	$252,595	$122,527	$375	$—	$122,902
Liabilities:								
Foreign exchange contracts	$—	$171	$—	$171	$—	$—	$—	$—
Total	$—	$171	$—	$171	$—	$—	$—	$—

Restricted Cash

As of June 30, 2014, restricted cash consisted of $38,000 which is classified as other current assets. As of December 31, 2013, restricted cash was $753,000. Of the $753,000 restricted cash balance as of December 31, 2013, $38,000 is classified as other current assets and $715,000 is classified as long-term other assets. These restricted cash accounts secure letters of credit applied against certain of the Company’s facility lease agreements.

Balance Sheet Hedging - Hedging of Foreign Currency Assets and Liabilities

During the six months ended June 30, 2014, the Company hedged certain of its nonfunctional currency denominated assets and liabilities to reduce the risk that earnings would be adversely affected by changes in exchange rates. Gains and losses from these forward contracts are recorded each period as a component of other income / (expense) in the consolidated statements of operations. The notional amount of derivative instruments acquired during the period was $127.8 million. The Company accounts for derivative instruments as other current assets and liabilities on the balance sheet and measures them at fair value with changes in the fair value recorded as other income / (expense). These derivative instruments do not subject the Company to material balance sheet risk due to exchange rate movements because gains and losses on these derivatives are intended to offset gains and losses on the assets and liabilities being economically hedged.

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As of June 30, 2014 and December 31, 2013, the Company had the following outstanding foreign exchange forward contracts:

	June 30, 2014		December 31, 2013	
	Notional Value Sold	Notional Value Purchased	Notional Value Sold	Notional Value Purchased
	(US dollars in thousands)		(US dollars in thousands)	
Australian dollar	$13,941	$6,420	$11,416	$4,979
British pound	9,985	6,013	7,537	4,799
Philippines peso	6,500	6,500	5,940	3,940
Czech crown	6,230	5,000	5,240	3,490
Japan yen	2,645	—	2,285	—
Canadian dollar	1,281	1,304	2,445	1,817
Euro	1,457	462	1,356	—
New Zealand dollar	553	102	287	—
Mexican peso	129	—	158	116
Total	$42,721	$25,801	$36,664	$19,141

The fair value of the derivative instruments reported on the Company’s Condensed Consolidated Balance Sheet were as follows:

	Asset Derivatives			Liability Derivatives		
Derivatives and forward contracts	Balance Sheet Location	June 30, 2014 Fair Value	December 31, 2013 Fair Value	Balance Sheet Location	June 30, 2014 Fair Value	December 31, 2013 Fair Value
	(in thousands)			(in thousands)		
Foreign exchange contracts	Other current assets	$17	$375	Other current liabilities	$171	$—
Total		$17	375		$171	$—

The effect of derivative instruments on the Statement of Operations and Comprehensive Loss was as follows for the periods presented:

Derivatives and forward contracts	Location of net gain (loss) recognized in income on derivatives	Amount of net gain (loss) recognized in income on derivatives during the Six Months Ended June 30, 2014	2013	Three Months Ended June 30, 2014	2013
		(in thousands)			
Foreign exchange contracts	Other income/ (expense), net	$(653)	$1,137	$(322)	$695
Total		$(653)	$1,137	$(322)	$695

The Company has entered into all of its foreign exchange contracts with a single counterparty. During the periods such contracts are open, the Company is subject to a potential maximum amount of loss due to credit risk equal to the gross fair value of the derivative instrument, if the counterparty to the instruments failed completely to perform according to the terms of the contracts. Generally, the Company has the right of offset for gains earned and losses incurred under these agreements. The agreements with the counterparty do not require either party to provide collateral to mitigate the credit risk of the agreements.

Note 4. Commitments and Contingencies

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The Company is involved in various legal proceedings and receives claims from time to time, arising from the normal course of business activities. The Company has accrued for estimated losses in the accompanying condensed consolidated financial statements for matters with respect to which it believes the likelihood of an adverse outcome is probable and the amount of the loss is reasonably estimable.

During the six months ended June 30, 2014, the Company entered into various office space leases to expand its operations within the United States, the Czech Republic and Australia. The corresponding lease terms for these agreements expire at various dates through 2021. The Company will pay a total of $7.4 million, net of any lessor lease incentives, over the corresponding lease terms.

Future minimum lease payments under non-cancelable operating leases (with initial or remaining lease terms in excess of one year) as of June 30, 2014 are as follows:

	Operating leases (dollars in thousands)
Years ending:	
Remainder of 2014	$6,749
2015	12,322
2016	10,596
2017	9,348
2018	9,445
Thereafter	9,377
Future minimum lease payments	$57,837

Note 5. Stock-based Compensation

During the first quarter of 2012, the Company made provisions for certain executives and other key employees to be awarded a total of 177,400 performance shares (“PS”) related to 2014. In the first quarter of 2014, the Company's Board of Directors ("BoD") set the performance metrics for these PS. The PS vesting is contingent upon the Company meeting certain company-wide revenue performance goals (performance-based) in 2014. These shares are subject to term vesting conditions. The PS fair value of $102.61 per share and the related stock-based compensation expense are determined based on the value of the underlying shares on the date of grant, which is in the first quarter of 2014 when the performance metrics were set by the BoD, and is recognized over the vesting term. During the interim financial periods, management estimates the probable number of PS that will be vested until the achievement of the performance goals is known at year end December 31, 2014.

Effective the first quarter of 2014, the Company changed its methodology for estimating the expected term assumption used to determine employee stock option grant fair value. The Company changed from the simplified method to a historical data method because the Company believes it has sufficient data to estimate the stock option exercise period based on historical stock option activity and historical employee termination data. The Company used a 4.32 years weighted average expected term to determine the fair value of stock options granted during the first quarter of 2014.

Note 6. Debt

0.25% Convertible Senior Notes

In June 2013, the Company issued at par value $310.0 million of 0.25% convertible senior notes due June 1, 2018 (the “Notes”). Interest is payable semi-annually in arrears on December 1 and June 1 of each year, commencing December 1, 2013.

The Notes are governed by an indenture dated as of June 4, 2013, between the Company, as issuer, and Wells Fargo Bank, National Association, as trustee. The Notes do not contain any financial covenants or any restrictions on the payment of dividends, the incurrence of senior debt or other indebtedness, or the issuance or repurchase of securities

by the Company. The Notes are unsecured and rank senior in right of payment to the Company's future indebtedness that is expressly subordinated in right of payment to the Notes, rank equal in right of payment to the Company's existing and future unsecured indebtedness that is not so subordinated. The Notes are effectively subordinated in right of payment to any of the Company's secured indebtedness to the extent of the value of the assets securing such indebtedness and are structurally subordinated to all existing and future indebtedness, liabilities incurred by our subsidiaries including trade payables, and preferred stock of the Company.

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Upon conversion, the Company may choose to pay or deliver, as the case may be, either cash, shares of the Company's common stock or a combination of cash and shares of the Company's common stock. If converted, holders will receive, at the Company's election, cash and/or shares of the Company's common stock for the principal amount of the Notes and any amounts in excess of the principal amounts. The Company intends to settle the principal amount of the Notes with cash if converted.
The initial conversion rate is 8.6133 shares of the Company's common stock per $1,000 principal amount of Notes, subject to anti-dilution adjustments. The initial conversion price is approximately $116.10 per share of the Company's common stock and represents a conversion premium of approximately 35% based on the last reported sale price of the Company's common stock of $86.00 on May 29, 2013, the date the Notes offering was priced. The conversion rate is subject to adjustment from time to time upon the occurrence of certain events, including, but not limited to, the issuance of stock dividends and payment of cash dividends. Holders of the Notes will not receive any cash payment representing accrued and unpaid interest upon conversion of a Note unless the conversion date occurs after a regular record date related to the Notes and prior to the related interest payment date. At any time prior to the close of business on the business day immediately preceding March 1, 2018, holders may convert their Notes at their option only under the following circumstances:

- during any calendar quarter commencing after the calendar quarter ended on September 30, 2013 (and only during such calendar quarter), if the last reported sale price of the common stock for at least 20 trading days (whether or not consecutive) during a period of 30 consecutive trading days ending on the last trading day of the immediately preceding calendar quarter is greater than or equal to 130% of the conversion price on each applicable trading day;

- during the five business day period after any five consecutive trading day period (the “measurement period”) in which the trading price per $1,000 principal amount of Notes for each trading day of the measurement period was less than 98% of the product of the last reported sale price of the Company's common stock and the conversion rate on each such trading day; or

- upon the occurrence of certain corporate transactions described in the indenture governing the Notes.

On and after March 1, 2018 until the close of business on the business day immediately preceding the maturity date, holders may convert their Notes at any time, regardless of the foregoing circumstances. If a make-whole fundamental change (as defined in the Indenture governing the Notes) occurs when the Company's stock price is between $86.00 and $275.00 per share and a holder elects to convert its Notes in connection with such make-whole fundamental change, such holder may be entitled to an increase in the conversion rate as provided for in the Indenture governing the Notes.
As of June 30, 2014, circumstances that would give rise to a conversion option for the holders of Notes do not exist. Holders of the Notes have the right to require the Company to purchase with cash all or a portion of the Notes upon the occurrence of any event that constitutes a fundamental change (as defined in the Indenture governing the Notes) at a purchase price equal to 100% of the principal amount of the Notes plus accrued and unpaid interest.

In accounting for the issuance of the Notes, the Company separated the Notes into liability and equity components. The carrying amount of the liability component was calculated by measuring the fair value of a similar liability that does not have an associated convertible feature. The carrying amount of the equity component representing the conversion option was determined by deducting the fair value of the liability component from the par value of the Notes as a whole. The excess of the principal amount of the liability component over its carrying amount (“debt discount”) is amortized to interest expense using the effective interest method over the term of the Note. The equity component is not remeasured as long as it continues to meet the conditions for equity classification.
In accounting for the $8.4 million in transaction costs related to the Note issuance, the Company allocated the total amount incurred to the liability and equity components based on their relative values. The $6.7 million in transaction

costs attributable to the liability component included in other assets are being amortized to interest expense over the term of the Notes, and the $1.7 million in transaction costs attributable to the equity component were netted with the equity component in additional paid-in capital. Debt issuance costs, net of amortization, were $5.3 million as of June 30, 2014. The Notes consisted of the following as of June 30, 2014

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	(in thousands)
Equity component (1)	$60,931
Liability component :	
Principal	$310,000
Less: debt discount, net	(50,242)
Net carrying amount	$259,758
Fair value - level 2	$318,835

(1) Included in the consolidated balance sheets within additional paid-in capital, net of the $1.7 million in equity issuance costs.

The Notes are carried at face value less any unamortized debt discount and also require disclosure of an estimate of fair value. The Company considers the fair value of the Notes at each balance sheet date to be a level 2 measurement because it is determined based on a recent quoted market price or dealer quote for the Notes. The Notes quoted market price or dealer quote is based on the trading price of the Company's common stock and market activity that is less than an active exchange.

As of June 30, 2014, the remaining life of the Notes is approximately 4.0 years.

The following table sets forth total interest expense recognized related to the Notes during the six and three months ended June 30, 2014:

	Six Months Ended June 30,		Three Months Ended June 30,	
	2014	2013	2014	2013
	(dollars in thousands)			
Contractual interest expense	$388	$65	$194	$65
Amortization of debt issuance costs	612	110	307	110
Amortization of debt discount	5,721	946	2,883	946
Total	$6,721	$1,121	$3,384	$1,121
Effective interest rate		5.4%		

Note 7. Income Taxes

The Company has incurred annual operating losses since inception. As a result of those continuing losses, management has determined insufficient evidence exists to support that it is more likely than not that the Company will realize the benefits of its U.S. net deferred tax assets and therefore has recorded a valuation allowance to reduce the net carrying value of these deferred tax assets to zero. Accordingly, the Company has not recorded a provision for income taxes for any of the periods presented other than provisions for state and foreign income taxes.

As of June 30, 2014, the Company had net deferred tax assets in certain foreign jurisdictions of approximately $210,000. Based on all available evidence, both positive and negative, management believes that it is more likely than not that the benefits of those foreign deferred tax assets will be realized in full. The Company also had deferred tax assets of $3.8 million for Japan where it had a full valuation allowance as of June 30, 2014, reducing its carrying value to zero.

The Company does not anticipate a material change in the total amount or composition of its unrecognized tax benefits within 12 months of the reporting date.

As of June 30, 2014, the Company has not provided for residual U.S. taxes on any of its income from foreign jurisdictions since it intends to indefinitely reinvest the net undistributed earnings of its foreign subsidiaries offshore.

The Company files federal, state and foreign income tax returns in jurisdictions with varying statutes of limitations. Due to the carry forward of net operating losses, the Company's income tax returns generally remain subject to examination by federal and most state tax authorities. In most of the Company's significant foreign jurisdictions, 2008 through the current taxable year remain subject to examination by their respective tax authorities.

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Note 8. Net Loss Per Share of Common Stock

Basic net loss per common share is computed by dividing net loss by the weighted-average number of shares of common stock outstanding during the period. Diluted net loss per share of common stock is computed by giving effect to all potential dilutive shares of common stock, including options, restricted stock units ("RSUs"), performance share units ("PSUs"), performance shares ("PS") and convertible debt shares. Basic and diluted net loss per share of common stock were the same for all periods presented as the impact of all potentially dilutive securities outstanding was anti-dilutive.

The following table presents the calculation of the numerator and denominator used in the basic and diluted net loss per share of common stock:

	Six Months Ended June 30,		Three Months Ended June 30,	
	2014	2013	2014	2013
	(dollars and shares in thousands, except per share amounts)			
Numerator:				
Net loss	$(45,397)	$(33,427)	$(23,164)	$(20,390)
Denominator:				
Weighted-average number of shares of common stock outstanding used in computing basic and diluted net loss per share of common stock	75,677	73,547	75,919	73,946
Net loss per share of common stock, basic and diluted	$(0.60)	$(0.45)	$(0.31)	$(0.28)

The Company’s unvested RSUs, PSUs and PS do not contain non-forfeitable rights to dividends and dividend equivalents. As such, unvested RSUs, PSUs and PS are not participating securities and the Company is not required to use the two-class method to calculate diluted earnings per share in periods when the Company has net income.

The following table presents the weighted average potential shares that are excluded from the computation of diluted net loss per common share for the periods presented because including them would have had an anti dilutive effect:

	Six Months Ended June 30,		Three Months Ended June 30,	
	2014	2013	2014	2013
	(Shares in thousands)			
Options to purchase shares of common stock	2,027	2,379	2,186	2,345
Unvested RSUs, PSUs and PS awards	2,649	3,165	2,722	3,313
Total	4,676	5,544	4,908	5,658

The effect of the convertible Notes is reflected in diluted earnings per share by application of the treasury stock method as the Company intends to settle the principal amount of the Note in cash upon conversion. During the six and three months ended June 30, 2014, the Company's weighted average common stock price was below the Notes conversion price for the periods during which the Notes were outstanding.

Note 9. Related Party Transactions

On February 28, 2013, the Company entered into the third amendment to the perpetual software license agreement with Oracle USA ("Amendment"). The Amendment provides for a 48 month extension to the May 2010 second amendment to the Oracle unlimited license agreement. The Amendment provides that the Company will pay a one-time fee of $13.1 million to extend the term for unlimited licenses from May 31, 2014 to May 31, 2018. The Amendment also provides for technical support services. The Company paid $2.4 million for the support services

from February 28, 2013 to February 27, 2014. During the first quarter of 2014, the Company renewed the support service agreement for $4.3 million and may renew support services for the three subsequent annual periods at the same rate. The support services to be provided to the Company by Oracle automatically renew unless the Company provides written notice of cancellation at least 60 days prior to the support renewal date. The Company financed the license fees due under the Amendment pursuant to a note issued to Oracle Credit Corporation. The note bears interest at a rate of 2.00% per annum with payments scheduled over the term of the amendment. The Company discounted the note at a rate of 4.5% because it approximates the interest rate the Company would obtain on the open market.

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The $12.4 million discounted note value was recorded as an asset addition to property and equipment that will be depreciated over seven years.
Future debt payments under notes payable as of June 30, 2014 are as follows:

	(dollars in thousands)
Years ending:	
Remainder of 2014	$1,559
2015	3,119
2016	3,119
2017	3,119
Future debt payments	10,916
Amount representing interest	873
Present value of future debt payments	$10,043

The following table details schedule payments made to Oracle USA and Oracle Credit Corporation:

	Six Months Ended June 30,		Three Months Ended June 30,	
	2014	2013	2014	2013
	(dollars in thousands)			
License fee	$1,713	$1,366	$659	$973
Support	2,150	1,193	1,075	1,190
Interest	250	157	120	144
Total paid	$4,113	$2,716	$1,854	$2,307

The Company has also entered into various other software license agreements with Oracle Corporation. During the six months ended June 30, 2014 and 2013, the Company received payments totaling $216,000 and $123,000, respectively, from Oracle Corporation for services it performed.
In addition to the companies affiliated with Lawrence J. Ellison, the Company enters into sales and purchases agreements with various companies that have a relationship with the Company's executive officers or members of the Company's board of directors. The relationships are typically an equity investment by the executive officer or board member in the customer / vendor company or the Company's executive officer or board member is a member of the customer / vendor company's board of directors. The Company has renewed the license agreements and sold additional services to these customers or purchased services from these vendors at various points in time. As of June 30, 2014, the Company 's accounts receivable related to these customers totaled $505,000. Below is a summary of transactions between the Company and related parties other than Mr. Ellison:

	Six Months Ended June 30,		Three Months Ended June 30,	
	2014	2013	2014	2013
	(dollars in thousands)			
Revenue earned from related party	$1,585	$934	$792	$372
Fees NetSuite paid for services	$352	$397	$278	$397

Additional related party transactions entered into prior to December 31, 2013 are described in the Notes to Consolidated Financial Statements included in the Company’s Annual Report on Form 10-K for the fiscal year ended December 31, 2013 filed on March 3, 2014.

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Note 10. Subsequent Event

On July 17, 2014, the Company completed the purchase of all the outstanding equity of Venda Limited (“Venda"), a private company that provides Ecommerce solutions to its customers. Venda expands the Company’s European customer base and adds certain functionality to the Company's product suite. Beginning in the third quarter of 2014, Venda assets, liabilities and operating results will be reflected in the Company’s condensed consolidated financial statements from the date of acquisition. On the closing date, the Company paid $25.3 million in cash and issued 304,364 shares of the Company's common stock valued at approximately $24.0 million to the former owners. Of the $25.3 million in consideration paid, $10.1 million is being held in escrow for up to two years following the close of the transaction as protection against taxes and certain losses the Company may incur in the event of certain breaches of representations and warranties covered in the purchase agreement. In the third quarter of 2014, the Company expects to identify the third party transaction costs incurred in connection with the Venda business combination and complete the valuation of the Venda assets acquired and the liabilities assumed on the transaction close date.

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

The following discussion and analysis is intended to provide greater details of our results of operations and financial condition and should be read in conjunction with our condensed consolidated financial statements and the notes thereto included elsewhere in this document and the discussion contained in our Annual Report on Form 10-K for the year ended December 31, 2013 as filed with the SEC on March 3, 2014. Certain statements in this Quarterly Report constitute forward-looking statements and as such, 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. Such forward-looking statements include any expectation of earnings, revenues or other financial items; any statements of the plans, strategies and objectives of management for future operations; factors that may affect our operating results; statements concerning new products or services; statements related to adding employees; statements related to future capital expenditures; statements related to future economic conditions or performance; statements related to the integration of acquired companies; statements as to industry trends and other matters that do not relate strictly to historical facts or statements of assumptions underlying any of the foregoing. These statements are often identified by the use of words such as "anticipate," "believe," "continue," "could," "estimate," "exp "intend," "may," or "will," and similar expressions or variations. Such forward-looking statements are subject to risks, uncertainties and other 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 discussed in the section titled "Risk Factors" included in Item 1A of Part II of this Quarterly Report on Form 10-Q, and the risks discussed in our other SEC filings.

We urge you to consider these factors carefully in evaluating the forward-looking statements contained in this Quarterly Report on Form 10-Q. These statements are based on the beliefs and assumptions of our management based on information currently available to management. The forward-looking statements included in this Quarterly Report are made only as of the date of this Quarterly Report. All subsequent written or oral forward-looking statements attributable to our company or persons acting on our behalf are expressly qualified in their entirety by these cautionary statements. We do not undertake, and specifically disclaim, any obligation to update any forward-looking statements to reflect the occurrence of events or circumstances after the date of such statements except as required by law.

Overview

NetSuite Inc. ("NetSuite" or the "Company") is the industry's leading provider of cloud-based financials / Enterprise Resource Planning ("ERP") and omnichannel commerce software suites. In addition to financials/ERP and omnichannel commerce software suites, we offer a broad suite of applications, including financial management, Customer Relationship Management ("CRM"), Ecommerce and retail management, Professional Services Automation ("PSA") and Human Capital Management ("HCM") that enable companies to manage most of their core business operations in our single integrated suite. Our "real-time dashboard" technology provides an easy-to-use view into up-to-date, role-specific business information. We also offer customer support and professional services related to implementing and supporting our suite of applications. We deliver our suite over the Internet as a subscription service using the software-as-a-service ("SaaS") model.
Our headquarters are located in San Mateo, California. We were incorporated in California in September 1998 and reincorporated in Delaware in November 2007. We conduct our business worldwide, with international locations in Canada, the United Kingdom, Spain, the Czech Republic, Japan, Hong Kong, the Philippines, Singapore, Australia and Uruguay.

Key Components of Our Results of Operations

Revenue

We generate sales directly through our sales team and, to a lesser extent, indirectly through channel partners. We sell our service to customers across a broad spectrum of industries, and we have tailored our service for wholesalers/distributors, manufacturers, e-tailers, services companies and software companies. The primary target customers for our service are medium-sized businesses and divisions of large companies. An increasing percentage of our customers and our revenue have been derived from larger businesses within this market. For the six and three months ended June 30, 2014, we did not have any single customer that accounted for more than 3% of our revenue.

We are pursuing a number of strategies that we believe will enable us to continue to grow. The goals of those strategic objectives are to continue to move up market; to increase use of NetSuite as a platform; and to extend the verticalization of our

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product line. Although we have made progress towards our goals in recent periods, there are still many areas where we believe that we can continue to grow. To achieve these goals, we are focused on the following initiatives:

- Growth of sales of OneWorld, our platform for ERP, CRM and Ecommerce capabilities in multi-currency environments across multiple subsidiaries and legal entities, which supports the needs of large, standalone companies, and divisions of very large enterprises;
- Strengthening our offerings for targeted industries such as wholesale/distribution, manufacturing, e-tail, retail, technology and professional services by adding deeper verticalized functionality; and
- Developing our SuiteCloud ecosystem to enable third parties to extend our offerings with their vertical expertise or horizontal solution.

We experience competitive pricing pressure when our products are compared with solutions that address a narrower range of customer needs or are not fully integrated (for example, when compared with Ecommerce or CRM stand-alone solutions). In addition, since we sell primarily to medium-sized businesses, we also face pricing pressure in terms of the more limited financial resources or budgetary constraints of many of our target customers. We do not currently experience significant pricing pressure from competitors that offer a similar on-demand, integrated business management suite.

We sell our application suite pursuant to subscription agreements. For the most part, the duration of subscription and support agreements is 12 to 36 months. We rely in part on a large percentage of our customers to renew their agreements to drive our revenue growth. Our customers have no obligation to renew their subscriptions after the expiration of their subscription period.

We generally invoice our customers in advance in monthly, annual or quarterly installments, and typical payment terms provide that our clients pay us within 30 to 60 days of invoice. Amounts that have been invoiced where the customer has a legal obligation to pay are recorded in accounts receivable and deferred revenue. As of June 30, 2014, we had deferred revenue of $252.2 million.

Our subscription agreements provide service level commitments of 99.5% uptime per period, excluding scheduled maintenance. The failure to meet this level of service availability may require us to credit qualifying customers up to the value of an entire month of their subscription and support fees. In light of our historical experience with meeting our service level commitments, we have not accrued any liabilities on our balance sheet for these commitments.

As part of our overall growth, we expect the percentage of our revenue generated outside of the United States to increase as we invest in and enter new markets. Revenue by geographic region, based on the billing address of the customer, was as follows for the periods presented:

	Six Months Ended June 30,		Three Months Ended June 30,	
	2014	2013	2014	2013
	(dollars in thousands)			
United States	$192,064	$143,702	$100,401	$75,812
International	62,691	48,923	31,393	25,184
Total revenue	$254,755	$192,625	$131,794	$100,996
Percentage of revenue generated outside of the United States	25 %	25 %	24 %	25 %

Employees

The number of full-time employees as of June 30, 2014 was 2,762 as compared to 2,434 at December 31, 2013 and 2,138 at June 30, 2013. As of June 30, 2014, our headcount included 838 employees in sales and marketing; 1,002 employees in operations, professional services, training and customer support; 666 employees in product

development; and 256 employees in a general and administrative capacity.

Cost of Revenue

Subscription and support cost of revenue primarily consists of costs related to hosting our application suite, providing customer support, data communications expenses, personnel and related costs of operations, stock-based compensation, software license fees, outsourced subscription services, costs associated with website development activities, allocated

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overhead, amortization expense associated with capitalized internal use software and acquired developed technology, and related plant and equipment depreciation and amortization expenses.

Professional services and other cost of revenue primarily consists of personnel and related costs for our professional services employees and executives, external consultants, stock-based compensation and allocated overhead.

We allocate overhead such as rent, information technology costs and employee benefit costs to all departments based on headcount. Recruiting costs are systematically allocated to the respective departments that utilize recruiting services during the period. As such, general overhead expenses are reflected in cost of revenue and each operating expense category.
We expect cost of revenue to increase in absolute dollars over the near term; however, it could fluctuate period to period depending on the growth of our professional services business.

Operating Expenses - Product Development

Product development expenses primarily consist of personnel and related costs for our product development employees and executives, including salaries, stock-based compensation, employee benefits and allocated overhead. Our product development efforts have been devoted primarily to increasing the functionality and enhancing the ease of use of our on-demand application suite, as well as localizing our product for international use. A key component of our strategy is to expand our business internationally. This will require us to conform our application suite to comply with local regulations and languages, causing us to incur additional expenses related to translation and localization of our application for use in other countries.

At our product development facility in the Czech Republic, we participate in a government program that subsidizes us for employing local residents. Under the program, the Czech government will reimburse us for certain operating expenses we incur. Since the first quarter of 2012, we have reduced our product development expenses for eligible operational expenses we expect the Czech government to reimburse. On a quarterly basis, we will accrue our expected subsidies for the duration of the program. During the second quarter of 2014, we began participating in a second subsidy program, similar in nature to the initial program, as benefits under the initial program reached the program limits in the first quarter of 2014.

We expect product development expenses to increase in absolute dollars as we continue to extend our service offerings internationally and as we expand and enhance our application suite technologies. Such expenses may vary due to the timing of these offerings and technologies.

Operating Expenses - Sales and Marketing

Sales and marketing expenses primarily consist of personnel and related costs for our sales and marketing employees and executives, including wages, benefits, bonuses, commissions and training, stock-based compensation, commissions paid to our channel partners, the cost of marketing programs such as on-line lead generation, promotional events, webinars and other meeting costs, amortization of intangible assets related to trade name and customer relationships and allocated overhead. We market and sell our application suite worldwide through our direct sales organization and indirect distribution channels such as strategic resellers. We capitalize and amortize our direct and channel sales commissions over the period the related revenue is recognized.
We expect to continue to invest in sales and marketing to pursue new customers and expand relationships with existing customers. As such, we expect our sales and marketing expenses to increase in terms of absolute dollars for the remainder of 2014.

Operating Expenses - General and Administrative

General and administrative expenses primarily consist of personnel and related costs for executive, finance, human resources and administrative personnel, stock-based compensation, legal and other professional fees, other corporate expenses and IT, facility and recruiting costs allocated to other departments.
We expect our general and administrative expenses to increase in terms of absolute dollars for the remainder of 2014.

Income Taxes

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Since inception, we have incurred annual operating losses and, accordingly, have not recorded a provision for income taxes for any of the periods presented other than provisions for state and foreign income taxes.

Critical Accounting Policies and Judgments

Our condensed consolidated financial statements are prepared in accordance with GAAP. The preparation of these condensed consolidated financial statements requires us to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenue, costs and expenses and related disclosures. We base our estimates on historical experience and on various other assumptions that we believe to be reasonable under the circumstances. In many instances, we could have reasonably used different accounting estimates, and in other instances changes in the accounting estimates are reasonably likely to occur from period-to-period. Accordingly, actual results could differ significantly from the estimates made by our management. To the extent that there are material differences between these estimates and actual results, our future financial statement presentation, financial condition, results of operations and cash flows will be affected.

In many cases, the accounting treatment of a particular transaction is specifically dictated by GAAP and does not require management's judgment in its application, while in other cases, significant judgment is required in selecting among available alternative accounting standards that allow different accounting treatment for similar transactions. We consider these policies requiring significant management judgment to be critical accounting policies. These critical accounting policies are:

- Revenue recognition;
- Internal use software and website development costs;
- Deferred commissions;
- Accounting for stock-based compensation; and
- Goodwill and other intangible assets

Effective the first quarter of 2014, we changed our methodology for estimating the expected term assumption used to determine employee stock option grant fair value. We changed from the simplified method to a historical data method because we believe we have sufficient data to estimate the stock option exercise period based on historical stock option activity and historical employee termination data.

Other than the change in determining the expected term assumption, there have been no significant changes in our critical accounting policies and estimates during the six months ended June 30, 2014 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 Judgments" included in our Annual Report on Form 10-K for the year ended December 31, 2013 filed on March 3, 2014. In addition, please see Note 2 of Notes to the Condensed Consolidated Financial Statements included in this Quarterly Report on Form 10-Q and Note 2 of the Notes to Consolidated Financial Statements included in our 2013 Annual Report on Form 10-K filed on March 3, 2014 for a description of our accounting policies.

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Results of Operations

Revenue, Cost of Revenue, Gross Profit and Gross Margin

Information about revenue, cost of revenue, gross profit and gross margin was as follows for the periods presented:

	Six Months Ended June 30,		Three Months Ended June 30,	
	2014	2013	2014	2013
	(dollars in thousands)			
Revenue:				
Subscription and support	$205,246	$154,199	$105,851	$80,239
Professional services and other	49,509	38,426	25,943	20,757
Total revenue	254,755	192,625	131,794	100,996
Cost of revenue (1):				
Subscription and support	33,444	25,826	17,084	13,511
Professional services and other	46,830	37,225	24,513	19,895
Total cost of revenue	80,274	63,051	41,597	33,406
Gross profit	$174,481	$129,574	$90,197	$67,590
Gross margin	68 %	67 %	68 %	67 %

(1) Includes stock-based compensation expense and amortization of intangible assets and severance and transaction costs associated with business combinations of:

Cost of revenue:				
Subscription and support	$3,837	$2,715	$1,851	$1,588
Professional services and other	4,799	4,298	2,317	2,452
	$8,636	$7,013	$4,168	$4,040

Six Months Ended June 30, 2014 as Compared to the Six Months Ended June 30, 2013

Revenue for the six months ended June 30, 2014 increased $62.1 million, or 32%, compared to the same period in 2013.

Subscription and support revenue: Subscription and support revenue for the six months ended June 30, 2014 increased $51.0 million, or 33%, compared to the same period in 2013. The increase was primarily the result of a $34.4 million increase in revenue resulting from the acquisition of new customers, and a $16.6 million increase in revenue from existing customers, both of which included the continued adoption of OneWorld.

Professional services and other revenue: Professional services and other revenue for the six months ended June 30, 2014 increased $11.1 million, or 29%, compared to the same period in 2013. The increase was primarily the result of a $24.3 million increase in revenue resulting from the acquisition of new customers. As we move up market to larger customers, the scope of our professional services engagements has increased resulting in an increase in demand for our professional services. Additionally, existing customers have purchased additional product modules which has also resulted in an increase in demand for our professional services. The increase in professional services and other revenue was partially offset by a $13.2 million decrease in revenue from existing customers related to services purchased in connection with the initial implementation of our product in 2013 that did not recur for those customers in 2014.

Revenue generated outside of the United States was $62.7 million, or 25%, of our total revenue for the six months ended June 30, 2014 as compared to $48.9 million, or 25%, for the same period in 2013. Revenue generated in the United States grew at higher rate than revenue outside of the United States except for in the United Kingdom.

Cost of revenue for the six months ended June 30, 2014 increased $17.2 million, or 27%, compared to the same period in 2013.

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Subscription and support cost of revenue: Subscription and support cost of revenue for the six months ended June 30, 2014 increased $7.6 million, or 29%, compared to the same period in 2013. The increase was primarily the result of a $4.4 million increase in data center production costs, a $2.4 million increase in personnel costs and a $874,000 increase in IT, facility and other operating expenses. Data center and other production costs increased due to an increase in support costs, depreciation, amortization of intangibles related to our 2013 business acquisitions, amortization of capitalized internal use software costs and other operational costs associated with an increase in our data center capacity and activity. Personnel costs increased due to an increase in headcount and incentive bonuses. IT, facility and other operating expenses related to our data center increased due to rising vendor costs and an increase in recruiting and other costs incurred to grow our business.

Professional services and other cost of revenue: Professional services and other cost of revenue for the six months ended June 30, 2014 increased $9.6 million, or 26%, compared to the same period in 2013. The increase was primarily the result of a $6.3 million increase in personnel costs, a $2.0 million increase in IT, facility and other operating expenses and a $1.3 million increase in fees related to outsourced consulting services. Personnel costs increased due to an increase in headcount and annual merit increases. Headcount increased as a result of an increase in the demand for our professional services. IT, facility, recruiting and other operating expenses related to our professional services increased by $2.0 million primarily due to our global expansion. The net increase in outsourced consulting fees resulted from professional service fees incurred to develop our professional services organization, partially offset by a decrease in other outside consultant costs.

Our gross margin increased to 68% during the six months ended June 30, 2014 from 67% during the same period in 2013. Our gross margin increased from the same period in 2013 primarily due to an increase in the average deal selling price and because our revenue growth rate for subscription services was higher than our revenue growth rate for professional services.

Three Months Ended June 30, 2014 as Compared to the Three Months Ended June 30, 2013

Revenue for the three months ended June 30, 2014 increased $30.8 million, or 30%, compared to the same period in 2013.
Subscription and support revenue: Subscription and support revenue for the three months ended June 30, 2014 increased $25.6 million, or 32%, compared to the same period in 2013. The increase was primarily the result of a $16.9 million increase in revenue resulting from the acquisition of new customers, the continued adoption of OneWorld and a $8.7 million increase in revenue from existing customers.

Professional services and other revenue: Professional services and other revenue for the three months ended June 30, 2014 increased $5.2 million, or 25%, compared to the same period in 2013. The increase was primarily the result of a $12.1 million increase in revenue resulting from the acquisition of new customers. As we move up market to larger customers, the scope of our professional services engagements has increased resulting in an increase in demand for our professional services. Additionally, existing customers have purchased additional product modules, which has also resulted in an increase in demand for our professional services. The increase in professional services and other revenue was partially offset by a $6.9 million decrease in revenue from existing customers related to services purchased in connection with the initial implementation of our product in 2013 that did not recur for those customers in 2014.

Revenue generated outside of the United States was $31.4 million, or 24%, of our total revenue for the three months ended June 30, 2014 as compared to $25.2 million, or 25%, for the same period in 2013. Revenue generated in the United States grew at higher rate than revenue outside of the United States except for in the United Kingdom.

Cost of revenue for the three months ended June 30, 2014 increased $8.2 million, or 25%, compared to the same period in 2013.

Subscription and support cost of revenue: Subscription and support cost of revenue for the three months ended June 30, 2014 increased $3.6 million, or 26%, compared to the same period in 2013. The increase was primarily the result of a $2.1 million increase in data center production costs, a $1.0 million increase in personnel costs and a $486,000 increase in IT, facility and other operating expenses. Data center and other production costs increased due to an increase in support costs, depreciation, amortization of intangibles related to our 2013 business acquisitions, amortization of capitalized internal use software costs and other operational costs associated with an increase in our data center capacity and activity. Personnel costs increased due to an increase in headcount and incentive bonuses. IT, facility and other operating expenses related to our data center increased due to rising vendor costs and an increase in recruiting and other costs incurred to grow our business.

Professional services and other cost of revenue: Professional services and other cost of revenue for the three months ended June 30, 2014 increased $4.6 million, or 23%, compared to the same period in 2013. The increase was primarily the

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result of a $3.3 million increase in personnel costs and a $1.3 million increase in IT, facility and other operating expenses. Personnel costs increased due to an increase in headcount, annual merit increases and incentive bonuses. Headcount increased as a result of an increase in the demand for our professional services. IT, facility and other operating expenses related to our professional services increased due to rising vendor costs and an increase in recruiting and other costs incurred to grow our business. The net increase in outsourced consulting fees resulted from professional service fees incurred to develop our professional services organization, partially offset by a decrease in other outside consultant costs.

Our gross margin increased to 68% during the three months ended June 30, 2014 from 67% during the same period in 2013. Our gross margin increased from the same period in 2013 primarily due to an increase in the average deal selling price and because our revenue growth rate for subscription services was higher than our revenue growth rate for professional services.

Operating Expenses

Operating expenses were as follows for the periods presented:

	Six Months Ended June 30,					
	2014			2013		
	Amount	% of revenue		Amount	% of revenue	
	(dollars in thousands)					
Operating expenses (1):						
Product development	$49,548	19	%	$35,446	18	%
Sales and marketing	133,406	52	%	100,712	52	%
General and administrative	28,139	11	%	25,174	13	%
Total operating expenses	$211,093	83	%	$161,332	84	%

	Three Months Ended June 30,					
	2014			2013		
	Amount	% of revenue		Amount	% of revenue	
	(dollars in thousands)					
Operating expenses (1):						
Product development	$25,376	19	%	$18,796	19	%
Sales and marketing	69,726	53	%	53,960	53	%
General and administrative	14,106	11	%	13,429	13	%
Total operating expenses	$					