EVOLVING SYSTEMS INC
Form 10-Q
May 11, 2007

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

x **Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**

For the quarterly period ended March 31, 2007

OR

o **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: 0-24081

EVOLVING SYSTEMS, INC.

(Exact name of registrant as specified in its charter)

Delaware (State or other jurisdiction of incorporation or organization)	**84-1010843** (I.R.S. Employer Identification No.)
9777 Pyramid Court, Suite 100 Englewood, Colorado (Address of principal executive offices)	**80112** (Zip Code)

(303) 802-1000
(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 ý No o

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

Large accelerated filer o Accelerated filer o Non-accelerated filer x

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

As of May 3, 2007 there were 17,657,028 shares outstanding of Registrant s Common Stock (par value $0.001 per share).

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PART I FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

EVOLVING SYSTEMS, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS
(in thousands except share data)
(unaudited)

	March 31, 2007	December 31, 2006
ASSETS		
Current assets:		
Cash and cash equivalents	$ 7,965	$ 5,076
Current portion of restricted cash	300	300
Contract receivables, net of allowance of $70 at March 31, 2007 and December 31, 2006	7,681	9,206
Unbilled work-in-progress	488	1,064
Deferred foreign income taxes		15
Prepaid and other current assets	1,513	1,686
Total current assets	17,947	17,347
Property and equipment, net	1,115	1,349
Amortizable intangible assets, net	5,776	6,155
Goodwill	26,069	26,027
Other long-term assets	412	460
Total assets	$ 51,319	$ 51,338
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Current portion of capital lease obligations	$ 38	$ 37
Current portion of long-term debt	2,125	2,000
Accounts payable and accrued liabilities	4,574	4,428
Deferred foreign income taxes	41	
Unearned revenue	10,451	10,079
Total current liabilities	17,229	16,544
Long-term liabilities:		
Capital lease obligations, net of current portion	24	34
Other long-term obligations	911	749
Long-term debt, net of current portion	10,561	11,370
Deferred foreign income taxes	1,139	1,202
Total liabilities	29,864	29,899
Commitments and contingencies (Note 10)		
Series B convertible redeemable preferred stock	6,130	11,281
Stockholders equity:		
Preferred stock, $0.001 par value; 2,000,000 shares authorized; 525,289 and 966,666 shares of Series B issued and outstanding as of March 31, 2007 and December 31, 2006, respectively (shown above)		
Common stock, $0.001 par value; 25,000,000 shares authorized; 17,577,284 and 16,233,646 shares issued and outstanding as of March 31, 2007 and December 31, 2006, respectively	18	16
Additional paid-in capital	74,241	68,825
Accumulated other comprehensive income	1,541	1,466
Accumulated deficit	(60,475)	(60,149)
Total stockholders equity	15,325	10,158
Total liabilities and stockholders equity	$ 51,319	$ 51,338

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

EVOLVING SYSTEMS, INC.
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(in thousands except per share data)
(unaudited)

	Three Months Ended March 31, 2007	2006
REVENUE		
License fees and services	$ 3,991	$ 3,899
Customer support	4,470	4,229
Total revenue	8,461	8,128
COSTS OF REVENUE AND OPERATING EXPENSES		
Costs of license fees and services, excluding depreciation and amortization	1,924	1,875
Costs of customer support, excluding depreciation and amortization	1,493	1,626
Sales and marketing	2,040	2,555
General and administrative	1,550	1,407
Product development	549	747
Depreciation	288	293
Amortization	388	897
Restructuring and other expense (recovery)	(1)	(14)
Total costs of revenue and operating expenses	8,231	9,386
Income (loss) from operations	230	(1,258)
Other income (expense):		
Interest income	64	38
Interest expense	(464)	(509)
Gain on extinguishment of debt	42	
Foreign currency exchange loss	(58)	(1)
Other expense, net	(416)	(472)
Loss before income taxes	(186)	(1,730)
Income tax expense (benefit)	140	(79)
Net loss	$ (326)	$ (1,651)
Basic and diluted loss per common share	$ (0.02)	$ (0.09)
Weighted average basic and diluted shares outstanding	19,153	19,066

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

EVOLVING SYSTEMS, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS EQUITY

AND COMPREHENSIVE LOSS

(in thousands, except share data)

(unaudited)

	Common Stock Shares	Amount	Additional Paid-in Capital	Accumulated Other Comprehensive Income	Total Accumulated Deficit	Stockholders Equity
Balance at December 31, 2006	16,233,646	$ 16	$ 68,825	$ 1,466	$ (60,149)	$ 10,158
Common stock issued pursuant to the Employee Stock Purchase Plan	19,507	1	16			17
Stock-based compensation expense			249			249
Preferred stock conversion	1,324,131	1	5,151			5,152
Comprehensive loss:						
Net loss					(326)	
Foreign currency translation adjustment				75		
Comprehensive loss						(251)
Balance at March 31, 2007	17,577,284	$ 18	$ 74,241	$ 1,541	$ (60,475)	$ 15,325

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

EVOLVING SYSTEMS, INC.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands)
(unaudited)

	Three Months Ended March 31, 2007	2006
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net loss	$ (326)	$ (1,651)
Adjustments to reconcile net loss to net cash provided by operating activities:		
Depreciation	288	293
Amortization of intangible assets	388	897
Amortization of debt issuance costs	64	57
Equity compensation	249	236
Gain on disposal of property and equipment	(1)	(13)
Gain on extinguishment of debt	(42)	
Foreign currency transaction losses, net	58	1
Benefit from foreign deferred income taxes	(9)	(180)
Change in operating assets and liabilities:		
Contract receivables	1,479	3,013
Unbilled work-in-progress	576	428
Prepaid and other current assets	161	(47)
Accounts payable and accrued liabilities	344	(742)
Unearned revenue	366	(15)
Other	161	
Net cash provided by operating activities	3,756	2,277
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchases of property and equipment	(233)	(110)
Proceeds from sale of property and equipment	1	13
Earnout payments from business combinations	(24)	
Net cash used in investing activities	(256)	(97)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Capital lease payments	(9)	(8)
Principal payments on long-term debt	(642)	(250)
Proceeds from issuance of common stock	17	51
Net cash used in financing activities	(634)	(207)
Effect of foreign exchange rate changes on cash	23	(27)
Net increase in cash and cash equivalents	2,889	1,946
Cash and cash equivalents at beginning of period	5,076	3,883
Cash and cash equivalents at end of period	$ 7,965	$ 5,829
Supplemental disclosure of other cash and non-cash transactions:		
Interest paid	$ 244	$ 269
Income taxes paid	$ 2	$ 441
Conversion of preferred stock into common stock	$ 5,152	$

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

EVOLVING SYSTEMS, INC.
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1 BASIS OF PRESENTATION

Organization - We are a global provider of software solutions and services to the wireless, wireline and IP carrier market. We maintain long-standing relationships with many of the largest wireline, wireless and IP communications carriers worldwide. Our customers rely on us to develop, deploy, enhance, maintain and integrate complex, highly reliable software solutions for a range of Operations Support Systems (OSS). We offer software products and solutions in three core areas: numbering solutions that enable carriers to comply with government-mandated requirements regarding number portability as well as providing phone number management and assignment capabilities; service activation solutions used to activate complex bundles of voice, video and data services for traditional and next generation wireless and wireline networks; and mediation solutions supporting data collection for both service assurance and billing applications.

Interim Consolidated Financial Statements The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America (GAAP) and in conformity with the instructions to Form 10-Q and Article 10 of Regulation S-X and the related rules and regulations of the Securities and Exchange Commission (SEC). Accordingly, certain information and note disclosures normally included in financial statements prepared in accordance with GAAP have been condensed or omitted pursuant to such rules and regulations. However, we believe that the disclosures included in these financial statements are adequate to make the information presented not misleading. The unaudited condensed consolidated financial statements included in this document have been prepared on the same basis as the annual consolidated financial statements, and in our opinion, reflect all adjustments, which include normal recurring adjustments necessary for a fair presentation in accordance with GAAP and SEC regulations for interim financial statements. The results for the three months ended March 31, 2007 are not necessarily indicative of the results that we will have for any subsequent period. These unaudited condensed consolidated financial statements should be read in conjunction with the audited consolidated financial statements and the notes to those statements for the year ended December 31, 2006 included in our Annual Report on Form 10-K.

Use of Estimates - The preparation of financial statements in conformity with accounting principles generally accepted in the U.S. requires us to make estimates and assumptions that 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 the reported amounts of revenue and expenses during the reporting period. We made estimates with respect to revenue recognition for estimated hours to complete projects accounted for using the percentage of completion method, allowance for doubtful accounts, income tax valuation allowance, fair values of long-lived assets, valuation of intangible assets and goodwill, useful lives for property, equipment and intangible assets, business combinations, capitalization of internal software development costs and fair value of stock-based compensation amounts. Actual results could differ from these estimates.

Foreign Currency Translation - Our functional currency is the U.S. dollar. The functional currency of our foreign operations, generally, is the respective local currency for each foreign subsidiary. Assets and liabilities of foreign operations denominated in local currencies are translated at the spot rate in effect at the applicable reporting date. Our consolidated statements of operations are translated at the weighted average rate of exchange during the applicable period. The resulting unrealized cumulative translation adjustment, net of applicable income taxes, is recorded as a component of accumulated other comprehensive income (loss) in stockholders equity. Realized and unrealized transaction gains and losses generated by transactions denominated in a currency different from the functional currency of the applicable entity are recorded in other income (loss) in the period in which they occur.

Principles of Consolidation - The consolidated financial statements include the accounts of Evolving Systems and subsidiaries, all of which are wholly owned. All significant intercompany transactions and balances have been eliminated in consolidation.

Goodwill - Goodwill is the excess of acquisition cost of an acquired entity over the fair value of the identifiable net assets acquired. Goodwill is not amortized, but tested for impairment annually or whenever indicators of impairment exist. These indicators may include a significant change in the business climate, legal factors, operating performance indicators, competition, sale or disposition of a significant portion of the business or other factors. For purposes of the goodwill evaluation, we compare the fair value of each of our reporting units to its respective carrying amount. If the carrying value of a reporting unit were to exceed its fair value, we would then compare the fair value of the reporting unit s goodwill to its carrying amount, and any excess of the carrying amount over the fair value would be charged to operations as an impairment loss.

Intangible Assets - Amortizable intangible assets consist primarily of purchased software and licenses, customer contracts and relationships, trademark and tradenames, and business partnerships acquired in conjunction with our purchases of CMS, TSE and Evolving Systems U.K. These finite life assets are amortized using the straight-line method over their estimated lives.

We assess the impairment of identifiable intangibles if events or changes in circumstances indicate that the carrying value of the asset may not be recoverable. Factors that we consider significant which could trigger an impairment analysis include the following:

- Significant under-performance relative to historical or projected future operating results;

- Significant changes in the manner of use of the acquired assets or the strategy of the overall business;
- Significant negative industry or economic trends; and/or
- Significant decline in our stock price for a sustained period.

If, as a result of the existence of one or more of the above indicators of impairment, we determine that the carrying value of intangibles and/or long-lived assets may not be recoverable, we compare the estimated undiscounted cash flows expected to result from the use of the asset and its eventual disposition to the asset s carrying amount. If an amortizable intangible or long-lived asset is not deemed to be recoverable, an impairment loss is recognized representing the excess of the asset s carrying value over its estimated fair value.

Revenue Recognition - We recognize revenue from two primary sources: license fees and services, and customer support, in accordance with Statement of Position (SOP) 97-2, Software Revenue Recognition, as amended and interpreted by SOP 98-9, Modification of SOP 97-2, Software Revenue Recognition, With Respect to Certain Transactions. Staff Accounting Bulletin (SAB) No. 104, Revenue Recognition, provides further interpretive guidance for public companies on the recognition, presentation and disclosure of revenue in financial statements. In addition to the criteria described below, we generally recognize revenue when an agreement is signed, the fee is fixed or determinable and collectibility is reasonably assured.

The majority of our license fees and services revenue is generated from fixed-price contracts, which provide for licenses to our software products and services to customize such software to meet our customers use. Generally, when the services are determined to be essential to the functionality of the delivered software, we recognize revenue using the percentage-of-completion method of accounting, in accordance with SOP 97-2 and SOP 81-1, Accounting for Long-Term Construction Type Contracts. The percentage of completion for each contract is estimated based on the ratio of direct labor hours incurred to total estimated direct labor hours. Since estimated direct labor hours, and changes thereto, can have a significant impact on revenue recognition, these estimates are critical and are reviewed regularly. Amounts billed in advance of services being performed are recorded as unearned revenue. Unbilled work-in-progress represents revenue earned but not yet billable under the terms of the fixed-price contracts. All such amounts are expected to be billed and collected within 12 months.

We may encounter budget and schedule overruns on fixed price contracts caused by increased labor or overhead costs. Adjustments to cost estimates are made in the periods in which the facts requiring such revisions become known. Estimated losses, if any, are recorded in the period in which current estimates of total contract revenue and contract costs indicate a loss.

In arrangements where the services are not essential to the functionality of the software, we recognize license revenue upon delivery. To the extent that Vendor-Specific Objective Evidence (VSOE) of the fair value of undelivered elements exists, fees from multiple element arrangements are unbundled and recorded as revenue as the elements are delivered. If VSOE for the undelivered elements does not exist, fees from such arrangements are deferred until the earlier of the date that VSOE does exist on the undelivered elements or all of the elements have been delivered.

Services revenue from fixed-price contracts is generally recognized using the proportional performance method of accounting, which is similar to the percentage of completion method described above. Revenue from professional services provided pursuant to time-and-materials based contracts and training services are recognized as the services are performed, as that is when our obligation to our customers under such arrangements is fulfilled.

Customer support, including maintenance revenue, is generally recognized ratably over the service contract period. When maintenance is bundled with the original license fee arrangement, its fair value, based upon VSOE, is deferred and recognized during the periods when services are provided.

Stock-based Compensation - We account for stock-based compensation under Statement of Financial Accounting Standards No. 123(Revised), Share-Based Payment (SFAS 123R). This statement replaced SFAS No. 123, Accounting for Stock-Based Compensation (SFAS 123) and superseded APB Opinion No. 25, Accounting for Stock Issued to Employees. Under SFAS 123R, we apply a fair-value-based measurement method to account for share-based payment transactions with employees and directors and record compensation cost for all stock awards granted after January 1, 2006 and awards modified, repurchased, or cancelled after that date. In addition, we record compensation costs associated with the vesting of unvested options outstanding at January 1, 2006 using the guidance under SFAS 123. Stock-based compensation is a non-cash expense because we settle these obligations by issuing shares of our common stock instead of settling such obligations with cash payments. Compensation cost for options is recognized on a straight-line basis over the vesting period using an estimated forfeiture rate. Effective January 1, 2006, stock option grants and employee stock purchase plan purchases were accounted for under SFAS 123R. We used the Black-Scholes model to estimate the fair value of each option grant on the date of grant. This model requires the use of estimates for expected term of the options and expected volatility of the price of our common stock.

Recent Accounting Pronouncements - We adopted Financial Accounting Standards Board (FASB) Interpretation No. 48, Accounting for Uncertainty in Income Taxes An Interpretation of FASB Statement No. 109 (FIN 48) effective January 1, 2007. FIN 48 clarifies the accounting for uncertainty in income tax benefits recognized in an enterprise s financial statements in accordance with SFAS 109. FIN 48 also prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. In addition, FIN 48 provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition.

We have an unrecognized domestic tax benefit of approximately $0.4 million which did not change significantly during the three months ended March 31, 2007. The application of FIN 48 would have resulted in a decrease to retained earnings of $0.4 million, except that the decrease was fully offset by the application of a valuation allowance. In addition, future changes in the unrecognized tax benefit will have no impact on the effective tax rate while the valuation allowance exists. We expect that the unrecognized tax benefit will not change significantly within the next twelve months.

We file our tax returns as prescribed by the tax laws of federal as well as various state and foreign jurisdictions in which we operate. We may be subject to examination by the Internal Revenue Service (IRS) for calendar years 2003 through 2006 and HM Revenue and Customs in the U.K. for calendar years 2005 and 2006. Additionally, any domestic net operating losses that were generated in prior years and utilized in these years may also be subject to examination by the IRS.

As discussed in Note 6 to the consolidated financial statements in the 2006 Form 10-K, we have a valuation allowance against the full amount of our domestic net deferred tax asset. We currently provide a valuation allowance against domestic deferred tax assets when it is more likely than not that the domestic portion of our deferred tax assets will not be realized. Our deferred tax asset valuation allowance decreased approximately $0.4 million during the three months ended March 31, 2007 to approximately $20.0 million as of March 31, 2007, which includes the impact of applying FIN 48.

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements (SFAS 157). SFAS 157 defines fair value, establishes a framework for measuring fair value under generally accepted accounting principles, and expands disclosures about fair value measurements. SFAS 157 is effective for financial statements issued for fiscal years and interim periods beginning after November 15, 2007. We have not completed our evaluation of the impact of this standard on our consolidated financial statements or our future estimates of fair value.

In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities - Including an Amendment of FASB Statement No. 115 (SFAS 159). SFAS 159 permits entities to choose to measure eligible items at fair value at specific election dates (the fair value option). Unrealized gains and losses on items for which the fair value option has been elected shall be reported in earnings at each subsequent reporting period. This accounting standard is effective for us beginning January 1, 2008. We are currently assessing the impact of SFAS 159.

NOTE 2 GOODWILL AND INTANGIBLE ASSETS

We recorded goodwill as a result of three acquisitions which occurred over the period from November 2003 to November 2004. We acquired CMS Communications, Inc. (CMS) in November 2003, Telecom Software Enterprises, LLC (TSE) in October 2004 and Tertio Telecoms Ltd. (Evolving Systems U.K.) in November 2004.

Changes in the carrying amount of goodwill by reporting unit were as follows (in thousands):

	License and Services		**Customer Support**		**Total**
	U.S.	**U.K.**	**U.S.**	**U.K.**	**Goodwill**
Balance as of December 31, 2006	$	$ 8,944	$ 6,033	$ 11,050	$ 26,027
Effects of changes in foreign currency exchange rates		19		23	42
Balance as of March 31, 2007	$	$ 8,963	$ 6,033	$ 11,073	$ 26,069

Our annual goodwill impairment test was conducted as of July 31, 2006, and we determined that goodwill was not impaired as of the test date. From July 31, 2006 through March 31, 2007, no events have occurred that we believe may have impaired goodwill.

Identifiable intangible assets are amortized on a straight-line basis over estimated lives ranging from one to seven years and include the cumulative effects of foreign currency exchange rates. As of March 31, 2007 and December 31, 2006, identifiable intangibles were as follows (in thousands):

	March 31, 2007 Gross Amount	Accumulated Amortization	Net Carrying Amount	December 31, 2006 Gross Amount	Accumulated Amortization	Net Carrying Amount	Weighted-Average Amortization Period
Purchased software	$ 2,042	$ 351	$ 1,691	$ 2,038	$ 237	$ 1,801	4.7 yrs
Purchased licenses	227	73	154	227	49	178	2.3 yrs
Trademarks and tradenames	880	94	786	879	63	816	7.0 yrs
Business partnerships	144	22	122	143	14	129	5.0 yrs
Customer relationships	3,663	640	3,023	3,657	426	3,231	5.6 yrs
	$ 6,956	$ 1,180	$ 5,776	$ 6,944	$ 789	$ 6,155	5.4 yrs

Amortization expense of identifiable intangible assets was $0.4 million and $0.9 million for the three months ended March 31, 2007 and 2006, respectively. As Evolving Systems U.K. uses the Great British pound as its functional currency, the amount of future amortization actually recorded will be based upon exchange rates in effect at that time. Expected future amortization expense related to identifiable intangibles based on our carrying amount as of March 31, 2007 was as follows (in thousands):

Years ending March 31,	
2008	$ 1,537
2009	1,263
2010	897
2011	872
2012	589
Thereafter	618
	$ 5,776

NOTE 3   EARNINGS PER COMMON SHARE

Basic earnings per share (EPS   ) is computed by dividing net income or loss available to common stockholders by the weighted average number of shares outstanding during the period, including common stock issuable under participating securities, such as the Series B Convertible Redeemable Preferred Stock (Series B Preferred Stock   ). Diluted EPS is computed using the weighted average number of shares outstanding, including participating securities, plus all potentially dilutive common stock equivalents. Common stock equivalents consist of stock options and shares held in escrow. The following is the reconciliation of the denominator of the basic and diluted EPS computations (in thousands):

	Three Months Ended March 31, 2007	2006
Weighted average common shares outstanding	16,695	16,166
Participating securities	2,458	2,900
Basic and diluted weighted average shares outstanding	19,153	19,066

Weighted average options to purchase 0.7 million and 1.9 million shares of common stock were excluded from the dilutive stock calculation for the three months ended March 31, 2007 and 2006, respectively, as their effect would have been anti-dilutive as a result of the net loss for the period. Weighted average options to purchase 3.4 million and 2.4 million shares of common stock were excluded from the dilutive stock calculation for the three months ended March 31, 2007 and 2006, respectively, because their exercise prices were greater than the average fair value of our common stock for the period.

NOTE 4   SHARE-BASED COMPENSATION

We adopted SFAS 123R effective January 1, 2006 using the modified prospective method. We previously applied the intrinsic-value-based method in accounting for the recognition of stock-based compensation arrangements and the fair value method only for disclosure purposes. Our statements of operations from January 1, 2006 forward include charges for stock-based compensation. We recognized $0.2 million, or $0.01 per share, of compensation expense in the statement of operations for the three months ended March 31, 2007 and $0.2 million, or $0.01 per share, of compensation expense in the statement of operations for the three months ended March 31, 2006 with respect to our stock-based compensation plans. The following table summarizes stock-based compensation expenses recorded in the consolidated statements of operations (in thousands):

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	Three Months Ended March 31,	
	2007	2006