

SERVICESOURCE INTERNATIONAL, INC.

Form 10-K

February 28, 2019

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

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

For the fiscal year ended December 31, 2018

or

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

For the transition period from _____ to _____

Commission file number 001-35108

SERVICESOURCE INTERNATIONAL, INC.

(Exact name of registrant as specified in its charter)

Delaware

81-0578975

(State or other jurisdiction of incorporation or organization) (I.R.S. Employer Identification No.)

717 17th Street, 5th Floor

80202

Denver, Colorado

(Address of principal executive offices)

(Zip Code)

(720) 889-8500

(Registrant's telephone number, including area code)

Securities registered pursuant to Section 12(b) of the Act:

Common Stock, \$0.0001 Par Value The Nasdaq Stock Market LLC

(Title of each class) (Name of each exchange on which registered)

Securities registered pursuant to Section 12(g) of the Act:

None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities

Act. Yes No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the

Act. Yes No

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 1934 during the preceding 12 months (or for such shorter period that the registrant was

required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

Indicate by check mark whether the registrant has submitted electronically every Interactive Data File required to be submitted 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 such files). Yes No

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§29.405 of this chapter) is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

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

Large accelerated filer Accelerated filer

Non-accelerated filer Smaller reporting company

Emerging growth company

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

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

The aggregate market value of the voting and non-voting common stock held by non-affiliates of the registrant, computed by reference to the closing price at which the common stock was sold on June 30, 2018, the last business day of the registrant's most recently completed second fiscal quarter, as reported on the Nasdaq Global Market, was \$304.3 million. Shares of common stock held by each executive officer, director and holder of 5% or more of the outstanding common stock have been excluded in that such persons may be deemed to be affiliates. This determination of affiliate status does not reflect a determination that such persons are affiliates of the registrant for any other purpose.

As of February 20, 2019, there were approximately 92,934,876 shares of the registrant's common stock outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the registrant's definitive Proxy Statement for its 2019 Annual Meeting of Stockholders are incorporated by reference in Part III of this Annual Report on Form 10-K. Such Proxy Statement will be filed with the U.S. Securities and Exchange Commission within 120 days after the end of the fiscal year to which this report relates. Except with respect to information specifically incorporated by reference in this Form 10-K, the Proxy Statement is not deemed to be filed as part of this Form 10-K.

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FORWARD LOOKING STATEMENTS

This report includes estimates, projections, statements relating to our business plans, objectives and expected operating results that are “forward-looking statements” within the meaning of the Private Securities Litigation Reform Act of 1995, Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. Forward-looking statements may appear throughout this report. These forward-looking statements are generally identified by the words “believe,” “project,” “expect,” “anticipate,” “estimate,” “intend,” “strategy,” “opportunity,” “plan,” “may,” “should,” “will,” “would,” “will be,” “will continue,” “will likely result,” and variations of such similar expressions. Forward-looking statements are based on current expectations and assumptions that are subject to risks and uncertainties that may cause actual results to differ materially. We describe risks and uncertainties that could cause actual results and events to differ materially in “Risk Factors” (Part I, Item 1.A. of this Form 10-K), “Quantitative and Qualitative Disclosures about Market Risk” (Part II, Item 7.A. of this Form 10-K) and “Management’s Discussion and Analysis of Financial Condition and Results of Operations” (Part II, Item 7 of this Form 10-K). We undertake no obligation to update or revise publicly any forward-looking statements, whether because of new information, future events, or otherwise.

“ServiceSource,” “the Company,” “we,” “us,” or “our”, as used herein, refer to ServiceSource International, Inc. and its wholly-owned subsidiaries, unless the context indicates otherwise.

PART I

ITEM 1. BUSINESS

Overview

ServiceSource International, Inc. is a global leader in outsourced, performance-based customer success and revenue growth solutions. Through our people, processes and technology, we grow and retain revenue on behalf of our clients — some of the world’s leading business-to-business companies — in more than 45 languages. Our solutions help our clients strengthen their customer relationships, drive improved customer adoption, expansion and retention and minimize churn. Our technology platform and best-practice business processes combined with our highly-trained, client-focused revenue delivery professionals and data from 20 years of operating experience enable us to provide our clients greater value for our customer success services than attained by our clients’ in-house customer success teams.

Our net revenue was \$238.3 million, \$239.1 million and \$252.9 million for the years ended December 31, 2018, 2017 and 2016, respectively.

Our Solutions

We leverage deep experience, analytical expertise, high-performance revenue delivery teams and unique technology to drive customer success, renewals, and inside sales through our solutions.

Our client-focused revenue delivery professionals receive extensive training and expertise in our clients’ businesses and are deployed as an extension of our clients’ brands. Through direct interaction with our clients’ end users, our revenue delivery professionals follow a sales process tailored specifically to improve end-customer retention, generate additional sales where needed, and meet our clients’ business objectives. Our solution is designed to optimize recurring revenue, provide customer success and enablement services, and maximize inside sales capabilities across different business-to-business revenue models, distribution models and segments, including hardware, software, Software-as-a-Service, industrial systems, information and media, as well as technology-enabled healthcare and life sciences. Our global revenue delivery centers, located in Bulgaria, Ireland, Japan, Malaysia, the Philippines, Singapore, the United Kingdom and the United States enable us to provide our solutions to our clients in 45 languages.

Our solutions span the entire lifecycle of our clients’ customers, from landing new customers (we provide lead generation, inside sales, and outsourced sales operations services), adoption (we provide customer onboarding and customer success management services), expansion (we provide cross-sell and upsell, warranty conversion, account-based marketing and channel recruitment and enablement) and renewals (we provide renewals management services, including the sale of maintenance and support service contracts for the products used by our clients’ end-users).

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Outsourced Sales Operations. Our sales enablement and quoting solutions, powered by robotic process automation, or RPA, advance our clients' renewal sales process with specialized resources handling the administrative work associated with renewals and subscriptions. We apply a standardized, best-practice approach to sales enablement and quoting across the opportunities we manage through a dedicated, trained team completely focused on quoting, data entry and bookings processing combined with an in-depth understanding of our clients' product SKUs, pricing and systems. In addition, we provide rigorous quality control through a dedicated quote audit team and analytics dashboards to monitor accuracy, throughput and cycle times.

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Customer Onboarding. Our revenue delivery teams proactively welcome our clients' new customers and ensure the customers are established for ongoing success. Using our best-practice processes developed over our 20 year history, we confirm successful implementation of our clients' products or services and promote adoption and use, including thorough reviews of customer usage and initial contact; brief demonstrations and reviews of key product features; identification and, if needed, escalation of support or implementation issues; delivery of basic training and/or product education; and supporting change management initiatives.

Customer Success Management. Our revenue delivery teams continuously monitor the health of our clients' customers; reinforce the unique value and benefits of our clients' products; and share customer feedback with our clients' product and marketing teams. Our revenue delivery professionals are specifically and continuously trained to articulate the value of our clients' products and services to their customers, which drives improved customer loyalty. In addition, we use our technology platform to provide predictive analytics to identify our clients' at-risk customers as well as to provide segmentation and analysis to assist in minimizing or avoiding churn.

Inside Sales, Lead Generation, and Cross-sell and Upsell Services. Our inside sales teams perform and are trained in accordance with high performing sales team methodologies to enable efficient and effective lead generation and inside sales activities for our clients. Our revenue delivery teams are specifically trained in the identification of cross-sell and upsell activities, including upgrading service/support level, uncovering additional assets/licenses, extending term length and product sales lead generation. We do this through expert data analysis, specifically designed account plans and partnerships with our clients' sales teams.

Warranty Conversion. We proactively engage with our clients' warranty customers with skilled revenue delivery teams who are trained to clearly articulate the benefits of an extended support and maintenance contract. In addition, we identify and engage customers who have lapsed warranty agreements.

Renewals Management. We help our clients develop a finely-tuned renewals management and growth strategy. We begin by analyzing our clients' existing business data, systems and processes to accurately diagnose our clients' renewal revenue challenges. The initial analysis is followed by our proposal of a tailored solution of expert selling services, technology and processes to achieve our clients' revenue growth and customer retention objectives. Our revenue delivery teams operate as an extension of our clients' brand and sales team, support either direct or channel selling models and have worldwide sales experience.

Our pay-for-performance model allows our clients to pay us either flat-rate or variable commissions based on the revenue we generate on their behalf. Fixed-fee arrangements are often used in quick deployments to address discrete target areas of our clients' needs or when a fixed fee best addresses our clients' business model. We also generate revenue through our professional services teams, who assist our clients with data optimization.

Our engagement with our clients begins in the pre-sales process and continues through their lifecycle.

Sales Performance Analysis. We typically begin engagements with our prospective clients by conducting in-depth interviews, analyzing their historical performance and future opportunity and evaluating their recurring revenue business using proprietary analytical models. We also use our breadth of experience to benchmark and identify service renewal opportunities, and to calculate our ability to improve our clients' performance based on our performance with similar types of businesses and revenue streams.

Business Case, Pricing and Contract Structuring. We use our reservoir of data and benchmarks to estimate the critical components of the business case and appropriate pricing model for prospective clients, whether for renewals, selling services, or lead generation. This intelligence is fundamental to our pay-for-performance business model.

Data Integration. We deploy our professional services teams to enable data integration at scale, combined with data enhancement, enablement, integration and optimization where needed.

Performance. Once a partnership is in place with one of our clients, we leverage our reporting platform and our data reservoir and performance optimization tools to enable, measure, analyze, benchmark and optimize the performance of our inside sales and revenue delivery teams.

Client Benchmarking and Continuous Improvement. Our extensive platform and the accumulation of 20 years of experience serve as the foundation for benchmarking our clients' evolving recurring revenue and end customer success performance against industry peers and previous period performance. We generally conduct quarterly business review

meetings and annual partnership reviews with our clients to review performance, identify potential weaknesses in their processes and determine opportunities for improvement and make recommendations that we believe will allow our clients and us to achieve higher levels of performance and efficiencies.

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- Developing and Delivering Applications. Our data reservoir fuels the opportunity data, sales methodologies, metrics and reporting dashboards that we engineer into our applications. Accordingly, we design our applications to leverage the transactional, analytical and industry data housed in PRISM, our technology platform.

Our Technology

Our Predictive Relationship Intelligence and Sales Management platform, or PRISM, is a combination of our proprietary tools, best-in-class industry solutions, application integrations, a proprietary recurring revenue data model and proven release management and operational procedures. We use PRISM within our client engagements to enable higher productivity and efficiency from our revenue delivery and operations teams in order to drive better outcomes for our clients. We specifically focus on process and productivity management, analytics that drive high-performing and effective sales teams, and customer retention and customer success insights.

Customer Success Management Technologies

We deploy customer success management technologies to our customer success services teams on behalf of our clients in order to enable our agreed-upon economic outcomes. The applications are our own proprietary intellectual property, based on our years of history supporting recurring revenue management and customer success management, combined with best-in-class third party technology. PRISM correlates product usage, billing and customer revenue management data with success plans to proactively trigger intelligent workflow automations, helping our precision customer success and revenue delivery professionals engage the right end customer with the right sales motion at the right time.

Renewal and Channel Management Technologies

We deploy applications that are uniquely designed for our revenue delivery professionals who are specifically focused on managing renewals, warranty conversions, install base out-of-warranty (IBOW) and channel engagements. These applications allow us to optimize the selling processes between revenue delivery professionals engaging with our clients' customers and operations services responsible for creating quotes and booking orders. These selling processes, and our purpose-built applications that facilitate them, are also extended to channel partners to drive channel sales performance in scenarios where our clients sell via one-tier or two-tier distribution. All of these applications are based on our proprietary data model to effectively capture and track key recurring revenue metrics that drive performance for our customer partnerships.

Inside Sales Technologies

Using the native functionality of PRISM paired with ServiceSource's unique capabilities enables our inside sales teams to support new selling opportunities by capturing and scoring leads, prioritizing engagements, and focusing on cross-sales for current customers.

Productivity Tools

We deploy productivity tools to our revenue delivery professionals that focus on performance management, knowledge management, communication and training. These tools allow managers to monitor and coach our selling teams to improve performance and efficiency and provide real-time communication and client related news to our revenue delivery team members. These tools are available to our selling teams via a proprietary and customized landing page, and include the following features:

Communication. Team chat functionality for easy and immediate communication to managers and other team members; a softphone tie-in that enables recording for training purposes as well as time and task tracking features; and customer contact look-up application.

Knowledge Management. Product knowledge to guide selling and accelerate new team member training/onboarding, including client social media and other client-related news feeds.

Productivity Tools. These features enable managers and team leaders to capture best practices and productivity metrics for training and sharing across teams, as well as suggesting selling motions and task prioritization to enable targeted and efficient selling motions.

Performance Management. All information from the productivity tools, including task tracking and time management, rolls up to the individual representative and managers in both an individual and aggregated manner to allow for

real-time tracking of performance relative to quarter goals.

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Each deployment of the productivity tools is customized to the particular client and region being serviced by the revenue delivery team member. To scale best practices from our highest-performing team members, we also deploy workforce optimization software and desktop analytics. As we learn from our high performers how to navigate complex client systems or manage sophisticated selling activities, we can easily share those practices with new hires, team members or incorporate them into our global learning methodologies. Lastly, much of this information integrates with PRISM, our reporting platform of transactional, productivity and performance information to allow us to offer our clients benchmarking of our clients' results against their industry peers.

Our intellectual property consists primarily of software systems and business methodologies. We rely upon a combination of copyrights, trade secrets and trademarks, in addition to contractual restrictions such as confidentiality agreements, to establish and protect our proprietary rights. We currently hold twelve U.S. patents, and additional applications for U.S. patents are currently pending.

Key Benefits of Our Solutions Include:

Financial Benefits

Increased revenue. Our solutions are designed to increase revenues for our clients. We actively monitor the success rates-including contract renewal rates, cross-sell and upsell rates, lead generation, or other services that we drive on behalf of our clients in each engagement. When we generate higher renewal rates, we not only drive incremental client revenue for the associated period, but also have a compounding effect in increasing the base number of contracts eligible for renewal in subsequent periods, which expands the opportunity to generate greater client revenue in future periods. As we expand our solution to include cross-sell and upsell, lead generation and other strategic customer success services, we believe that our opportunity to generate client revenue in future periods through our renewal management services will also increase.

Improved retention and customer success. Our solutions drive end customer retention and revenue growth for some of the world's leading companies, leveraging 20 years of expertise to continuously monitor end customer health, engage each end customer with the right play at the right time and reinforce the unique value and benefits of each end customer's product. The result is reduced end customer churn, increased revenue through up-sell and cross-sell, stronger end customer relationships and higher satisfaction.

Increased margin and profitability. We believe that the variable rate we charge for our solutions is lower than the fully-loaded fixed internal costs incurred by our clients managing renewals internally. As a result, each incremental dollar of recurring revenue generated by our solutions can drive greater profitability for our clients.

Operational Benefits

Greater business insight and analytics. The analytics engines in our technologies allow us to analyze each client's renewals and churn rates against similar transactions, identifying areas for improvement and enabling greater insight into their business. All transactions, regardless of outcome, are recorded in PRISM. We leverage PRISM to provide benchmarking, end customer metrics, sales efficiency data and insight into successful and unsuccessful renewal efforts. The breadth of our data allows us to provide powerful analysis across regions, industries, channel partners and product segments.

Greater visibility and forecasting tools. Our technologies deliver real-time analytics and visibility into our client's recurring revenue performance, sales efficiency and forecasts. We measure recurring revenue performance across dozens of key performance indicators and provide real-time data to our clients through a clear and impactful web-based interface. Our clients rely on our applications to assist in forecasting their results and to measure progress against their forecasts on a real-time basis.

Global consistency. We are able to maintain a globally consistent customer success and revenue growth selling process for our clients. Our revenue delivery centers operate from a unified platform. Our technologies automate the application of best practices to recurring revenue renewals and customer success processes and provide all relevant constituencies with a consistent view of the data. This automation facilitates contract renewals and provides reliable performance management and analytics.

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Our Strategy

We intend to continue our industry leadership by delivering solutions to support the challenges faced by our clients in managing their revenue lifecycle. Our strategy to execute this vision is:

• Expand our client base. In order to expand our client base, we are offering rapid, smaller deployments to address our clients' discrete needs or to support fast-growth enterprises.

Increase footprint with existing clients to drive greater revenue per client. Our goal is to manage a greater portion of each client's recurring revenue. We have increasingly taken on the management of more than just one component of a client's recurring revenue, such as a specific product, market segment or geographic region, or adding selling services such as cross-sell and upsell services, to an existing client's renewal services. Because we baseline our clients' performance prior to any engagement, we are able to quantify our results for the client.

Continue to invest in our technologies. We believe that our ability to leverage our technology to drive increased productivity by our revenue delivery professionals through more efficient and engaging training and productivity management, as well as our revenue analytics capabilities, is critical to our value proposition. We will continue to invest in our automation processes and the innovation of PRISM, our technology platform, to lower our operating costs, increase the efficiency and success of our solutions and enhance our competitive differentiation.

Expand our investments in our people. Retention and enablement of our revenue delivery professionals is important to the success of our business. We have invested, and will continue to invest, in specific job-related next-generation training tailored to an individuals' specific role. In addition, we will continue to support and roll out our continuous leadership training and learning management program, designed to identify high potential leaders as well as motivate our workforce and provide avenues for success across our worldwide employee base. We believe these investments will not only result in improved performance for our clients, but will also continue to set us apart from potential competitors and how our clients manage customer success internally.

Our Clients

We target our solutions to business-to-business companies, within a range of industries including computer hardware, software, Software-as-a-Service ("SaaS"), telecommunications, healthcare, life sciences, media and industrial systems. As of December 31, 2018, we managed approximately 156 engagements across 57 clients.

The following table presents the percentage of revenue for our top clients:

	For the Year Ended December 31, 2018 2017 2016		
Top three clients:			
Cisco	14 %	15 %	14 %
VMware	13 %	12 %	11 %
Dell	10 %	11 %	11 %
Top ten clients:	67 %	66 %	66 %

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Our People

As of December 31, 2018, we had the following employees throughout the world:

December 31,
2018

NALA:

United States 1,127

EMEA:

Bulgaria 291

Republic of Ireland 238

United Kingdom 236

APJ:

Philippines 989

Malaysia 766

Singapore 179

Japan 88

Total⁽¹⁾ 3,914

⁽¹⁾ We are not subject to collective bargaining agreements with any of our employees.

Sales and Marketing

We sell our solutions through our global sales organization. Our sales representatives are organized by geographic regions: North America and Latin America ("NALA"); Europe, Middle East and Africa ("EMEA"); and Asia Pacific-Japan ("APJ"). In 2018, we generated 60% of our revenue in NALA, 25% in EMEA and 15% in APJ. See "Item.1A. Risk Factors" for a description of the risks associated with our foreign operations.

We generate client leads, accelerate sales opportunities and build brand awareness through our marketing programs. Our marketing programs target sales, services, customer success, account management, technology and finance executives within the computer hardware, software, SaaS, telecommunications, healthcare, life sciences, media and industrial systems industries. Our marketing programs are organized by geography and industry segment to focus on the unique needs of clients within the specific target markets.

We participate in industry trade shows and host local and regional events around the world to stimulate industry dialog on revenue lifecycle management and to promote our services. In addition, we actively seek to collaborate with other like-minded businesses where such collaboration can increase our market penetration or provide value to our customers.

Research and Development

We focus our research and development efforts on enhancing our technologies as well as creating complementary new capabilities to add to our solutions. Our development strategy is to identify features, business intelligence, applications and other technology elements that are, or are expected to be, needed by sales professionals, customer success and account management professionals, clients, channel partners and end customers to optimize recurring revenue performance and customer success. We are also continuing to invest in the development of our technologies to serve our clients' needs and enable greater operational efficiencies in our organization.

Competition

The market for outsourced customer success and revenue growth solutions is evolving. Historically, companies have managed their service renewals through internal personnel and relied upon a variety of technologies including spreadsheets, internally developed software and customized versions of traditional business intelligence tools and end-customer relationship management or enterprise resource planning software from vendors such as Oracle Corporation, SAP AG, salesforce.com, inc. and NetSuite, Inc. Some companies have made further investments in this area using firms such as Accenture and McKinsey & Company for technology consulting and education services focused on service renewals. These internally-developed solutions represent the primary alternative to our integrated approach of combining people, processes and technology to provide end-to-end optimized outsourced customer success and revenue growth solutions.

We believe we are the only company of scale operating at the intersection of three key customer-success vectors: business process outsourcing/business process as a service (including offerings from vendors such as Accenture, Genpact and Concentrix);

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business-to-business revenue enablement services (including offerings from vendors such as Omnicom, Publicis and Acxiom); and

data and analytics services (including offerings from vendors such as Lattice Engines, InsideSales.com and 6sense).

We believe our unique market position and our differentiated business model allows us to maintain our market presence, and our global scale and ability to provide our solutions in over 45 languages provides a competitive advantage over smaller companies entering the outsourced customer success space.

We believe our principal competitive differentiators include:

recurring revenue and customer success;

industry expertise, best practices and benchmarks;

ability to increase recurring revenue and renewal rates;

global capabilities;

completeness of solution;

performance-based pricing of solutions;

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

quality of the business and client insight and its ability to generate revenue and customer success;

size of upfront investment; and

size and financial stability of operations.

Although we currently have few direct competitors that offer integrated solutions at our scale, we expect competition and competitive pressure, from both new and existing competitors, to increase in the future.

Additional Information

We were formed as a Delaware limited liability company in 2002 and converted to a Delaware corporation in 2011.

Additional information about us is available on our website at <http://www.servicesource.com>. The information on our website is not incorporated into this annual report by reference and is not a part of this Form 10-K. We make available free of charge on our website our annual reports on Form 10-K, quarterly reports on Form 10-Q and current reports on Form 8-K and any amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended, as soon as reasonably practicable after those reports are electronically filed with, or furnished to, the SEC. In addition, the SEC maintains a website that contains reports, proxy and information statements, and other information regarding issuers that file electronically with the SEC at <http://www.sec.gov>. From time to time, we may use our website as a channel of distribution of material information about our company.

Financial and other important information regarding our business is routinely posted on and accessible at <http://ir.servicesource.com>.

ITEM 1A. RISK FACTORS

Investing in our common stock involves risk. Our operations and financial results are subject to various risks and uncertainties, including those described below, that could adversely affect our business, financial condition, results of operations, cash flows and the trading price of our common stock. You should carefully consider the risks described below and the other information in this Report on Form 10-K.

Risks Related to Our Business and Industry

Our business and growth depend substantially on clients renewing their agreements with us and expanding their use of our solution for additional available markets. Any decline in our client renewals, termination of ongoing engagements or failure to expand their relationships with us could harm our future operating results.

In order for us to improve our operating results and grow, it is important that our clients renew their agreements with us when the initial contract term expires and that we expand our client relationships to add new market opportunities and the related revenue management opportunity. Our clients may elect not to renew their contracts with us after their initial terms have expired or may elect to otherwise terminate our services, and we cannot assure you that our clients will renew service contracts with us at the same or higher level of service, if at all, or provide us with the opportunity to manage additional revenue management opportunities. Although our renewal rates have been historically higher than those achieved by our clients prior to their using our solution, some clients have still elected not to renew their agreements with us. Our clients' renewal rates may decline or fluctuate as a result of a number of factors, many of

which are beyond our control, including their satisfaction or

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dissatisfaction with our solution and results, our pricing, mergers and acquisitions affecting our clients or their end customers, the effects of economic conditions or reductions in our clients' or their end customers' spending levels. If our clients do not renew their agreements with us, renew on less favorable terms, terminate their services with us or fail to contract with us for additional services, our revenue may decline and our operating results may be adversely affected.

Our revenue will decline if there is a decrease in the overall demand for our clients' products and services.

A majority of our revenue is based on a pay-for-performance model, which means that we are paid a commission based on the service contracts we sell on behalf of our clients. If a particular client's products or services fail to appeal to its end customers, our revenue will decline for our work with that client. In addition, if end customer demand decreases for other reasons, such as negative news regarding our clients or their products, unfavorable economic conditions, shifts in strategy by our clients away from promoting the service contracts we sell in favor of selling their other products or services to their end customers, or if end customers experience financial constraints and terminate or fail to renew the service contracts we sell, we may experience a decrease in our revenue as the demand for our clients' service contracts declines. Similarly, if our clients come under economic pressure, they may be more likely to terminate their contracts with us or seek to restructure those contracts, and for clients whose contracts are up for renewal, they may seek to renew those contracts on less favorable terms. If one or more of our clients is under economic pressure due to decreasing customer demand, negative news, or other issues that impact the demand for their product or services, our business could suffer and we may experience a significant decrease in our revenue. If our performance falls short of our estimates, our client relationships will be at risk, our revenue will suffer and our ability to grow could be harmed.

A majority of our business depends on driving new or renewal revenue for our clients, and we then receive a commission on the new or renewal revenue that we generate on our clients' behalf. In some cases, our commission rates vary depending on our performance—for example, if we overperform compared to our estimates then we may receive a higher commission. In addition, our clients rely on us to accurately forecast our performance, especially because we drive revenue on their behalf. If our performance for a particular client is lower than anticipated, then our revenue for that client will also be lower than projected. If our performance falls short of expectations across a broad range of clients, or if they fall below expectations for a particularly large client, then the impact on our revenue and our overall business will be significant. In the event our performance is lower than expected for a given client, our margins will suffer because we will have already incurred a certain level of costs in both personnel and infrastructure to support the engagement. This risk is compounded by the fact that many of our client relationships can be terminated by the client if we fail to meet certain specified sales targets, including bookings rates, over a sustained period of time. If our performance falls to a level at which our revenue and client contracts are at risk, then our financial performance will decline and we may have difficulty attracting and retaining new clients.

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

The contracts that we enter into with our clients provide for sharing of information with respect to forecasts and plans for the renewal and sale of maintenance, support and subscription agreements of our clients. Our clients may use this forecasted data for a variety of purposes related to their business. Our forecasts are based upon the data our clients provide to us, and are inherently subject to significant business, economic and competitive uncertainties, many of which are beyond our control. In addition, these forecasted expectations are based upon historical trends and data that may not be true in subsequent periods. Any material inaccuracies related to these forecasts could lead to claims on the part of our clients related to the accuracy of the forecasted data we provide to them, or the appropriateness of our methodology. Any liability that we incur or any harm to our brand that we suffer because of inaccuracies in the forecasted data we provide to our clients could impact our ability to retain existing clients and harm our business. We depend on a limited number of clients for a significant portion of our revenue, and the loss of business from one or more of our key clients could adversely affect our results of operations.

Our top ten clients accounted for 67% of our revenue for the year ended December 31, 2018, and three clients each represented over 10% of our revenue during this period. A relatively small number of clients may continue to account

for a significant portion of our revenue for the foreseeable future. The loss of revenue from any of our significant clients for any reason, including the failure to renew our contracts, termination of some or all of our services, a change of relationship with any of our key clients, or the acquisition of one of our significant clients, may cause a significant decrease in our revenue.

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

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

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

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

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

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

Our client contracts generally provide that we will indemnify our clients for data privacy breaches caused by our act or omission. If a data privacy breach occurs, we could face contractual damages, damages and fees arising from our indemnification obligations, penalties for violation of applicable laws or regulations, possible lawsuits by affected individuals and significant remediation costs and efforts to prevent future occurrences. Insurance may not be able to cover these costs in full, in particular if the damages are large. In addition, whether there is an actual or a perceived breach of our security, the market perception of the effectiveness of our security measures could be harmed significantly and we could lose current or potential clients.

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

The solution we offer is complex, and we make errors from time to time. These may include human errors made in the course of managing the sales process for our clients as we interact with their end customers, or errors arising from our technology solution as it interacts with our clients' systems and the disparate data contained on such systems. For example, our employees enter codes to classify their interactions with our clients' end customers, and incorrect code entry could result in our clients' end customer not receiving the service or solution they requested, which in turn could lead to customer dissatisfaction or termination causing our client relationships to suffer and our revenue and our clients' revenue to decline. The costs incurred in correcting any material errors may be substantial. Any claims based on errors could subject us to exposure for damages, significant legal defense costs, adverse publicity and reputational

harm, regardless of the merits or eventual outcome of such claims.

If our new and/or enhanced technologies do not work as intended, our business could suffer.

We have invested significant resources in new third-party technologies designed to enhance our product offerings. The adoption of technologies entails a number of risks that could adversely affect our business and operating results, including:

- the risk of diverting the attention of our management and our employees from the day-to-day operations of the business;

- insufficient revenue to offset increased expenses associated with research, development and operational activities; and

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the chance that the technologies may not integrate with our existing tools and systems and fail to achieve the desired result.

If any of our new technologies do not work as intended, are not responsive to user preferences or industry or regulatory changes, are not appropriately timed with market opportunity, or do not enhance our product offerings, we may lose existing and potential clients or related revenue opportunities, in which case our results of operations may suffer.

We conduct operations in a number of countries and are subject to risks of international operations.

In 2018, approximately 40% of our revenue was related to operations located outside of the U.S. In addition, 71% of our employees are located in offices outside of the U.S. We expect to continue our international growth, with international revenue accounting for an increased portion of total revenue in the future. Our international operations involve risks that differ from or are in addition to those faced by our U.S. operations. These risks include different employment laws and rules and related social and cultural factors; different regulatory and compliance requirements, including in the areas of privacy and data protection, anti-bribery and anti-corruption, trade sanctions, marketing and sales and other barriers to conducting business; cultural and language differences; diverse or less stable political, operating and economic environments and market fluctuations; and civil disturbances or other catastrophic events that reduce business activity. If we are not able to efficiently adapt to or effectively manage our business in markets outside of the U.S., our business prospects and operating results could be materially and adversely affected. Although we have business continuity plans in place for our operations, an extended period of civil unrest that halts or significantly impedes operations could have a material adverse effect on our business.

Laws or public perception may eliminate or restrict our ability to use revenue delivery centers not located in the United States, which could have a material adverse impact on our business and results of operations.

The issue of companies outsourcing services to organizations operating in other countries is a politically sensitive topic and has been under heightened scrutiny in many countries, including the United States. We provide our outsourced customer success and revenue growth solutions in several non-U.S. locations, including the Philippines and Malaysia, and our growth strategy includes increasing reliance on these “offshore” revenue delivery centers. Many organizations and public figures in the United States have publicly expressed concern about a perceived association between offshore outsourcing providers and the loss of jobs in the United States, and the topic of offshore outsourcing has recently received a great deal of negative attention from the U.S. executive branch. Because of negative public perception about offshore outsourcing, measures aimed at limiting or restricting offshore outsourcing by United States companies are periodically considered in the U.S. Congress. Current or prospective clients may elect to perform such services themselves or may be discouraged from transferring these services from onshore to offshore providers to avoid negative perceptions that may be associated with using an offshore provider. Any slowdown or reversal of existing industry trends towards offshore outsourcing, including due to the enactment of any legislation restricting offshore outsourcing by U.S. companies, would harm our ability to provide certain of our services to our clients at a competitive and cost-effective price point and would have a material adverse effect on our business and results of operations.

Changes in the legal and regulatory environment that affect our operations, including laws and regulations relating to the handling of personal data, data security and cross-border data flows, may impede the adoption of our services, disrupt our business or result in increased costs, legal claims, or fines against us.

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

Our international operations and global client base relies increasingly on the movement of data across national boundaries. Legal requirements relating to the collection, storage, handling and transfer of personal data continue to

evolve, and additional regulation in those areas, some of it potentially difficult and costly for us to accommodate, is frequently proposed and occasionally adopted. Laws in many countries and jurisdictions, particularly in the European Union and Canada, govern the requirements related to how we store, transfer or otherwise process the private data provided to us by our clients. In addition, the centralized nature of our information systems at the data and operations centers that we use requires the routine flow of data relating to our clients and their respective end customers across national borders, both with respect to the jurisdictions within which we have operations and the jurisdictions in which we provide services to our clients. If this flow of data becomes subject to new or different restrictions, our ability to serve our clients and their respective end customers could be seriously impaired for an extended period of time.

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We also have entered into various model contracts and related contractual provisions to enable these data flows. For any jurisdictions in which these measures are not recognized or otherwise not compliant with the laws of the countries in which we process data, or where more stringent data privacy laws are enacted irrespective of international treaty arrangements or other existing compliance mechanisms, we could face increased compliance expenses and face penalties for violating such laws or be excluded from those markets altogether, in which case our operations could be materially damaged.

If we are unable to compete effectively, our business and operating results will be harmed.

The market for outsourced inside sales, customer success and revenue retention solutions is evolving and new competitors are emerging. Historically, internally developed solutions have represented the primary alternative to our offerings. However, we also face direct competition from smaller companies that offer specialized revenue management solutions as well as larger business process outsourcers that are moving into the revenue growth space. We believe that more competitors will emerge. Competitors may have greater name recognition, longer operating histories, well-established relationships with clients in our markets and substantially greater financial, technical, personnel and other resources than we have, and even a potentially broader array of offerings. Potential competitors of any size may be able to respond more quickly and effectively than we can to new or changing opportunities, technologies, standards or end customer requirements. Even if our solution is more effective than competing solutions, potential clients might choose new entrants unless we can convince them of the advantages of our integrated solution. We expect competition and competitive pressure, from both new and existing competitors, to increase in the future. Consolidation in the technology sector could harm our business in the event that our clients are acquired and their contracts are canceled.

Consolidation among technology companies in our target market has been robust in recent years, and this trend poses a risk for us. Acquisitions of our clients could lead to cancellation of our contracts with those end customers by the acquiring companies and could reduce the number of our existing and potential clients. For example, in January 2010, Oracle acquired our then-largest client, Sun Microsystems, as well as several of our smaller clients. Oracle elected to terminate our service contracts with each client because Oracle conducted its service revenue management internally. If mergers and acquisitions take place within our customer base, some of the acquiring companies may terminate, renegotiate and/or elect not to renew our contracts with the companies they acquire, which would reduce our revenue. In addition, acquisitions in our customer base may adversely impact our revenue even if the contract is not terminated. The sales we make on behalf of our customers are processed through our customers' billing and quoting platforms. If our customers are acquired or merge with another company and as a result, their billing platforms or the procedures for processing closed sales are changed or slowed down, we will be unable to close our sales and our closure rate, and therefore our revenue and our ability to keep our customers, could suffer.

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

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

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

Our overall performance depends in part on worldwide economic conditions that impact the technology sector and other technology-enabled industries such as healthcare, life sciences and industrial systems. For example, an economic downturn typically results in many businesses deferring technology investments, including purchases of new software, hardware and other equipment, and purchases of additional or supplemental maintenance, support and subscription

services. To a certain extent, these businesses also slow the rate of renewals of maintenance, support and subscription services for their existing technology base. Any future downturn could cause business end customers to stop renewing their existing maintenance, support and subscription agreements or contracting for additional maintenance services as they look for ways to further cut expenses, in which case our business could suffer.

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

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If our marketing programs fail to generate client leads, accelerate sales opportunities and build brand awareness in a cost-effective manner, it could have a material adverse effect on our business, financial condition and results of operations.

Our marketing programs are an important part of our strategy to generate client leads, accelerate sales opportunities and build brand awareness. The success of our marketing programs in a cost-effective manner is critical to our ability to achieve widespread acceptance of our solutions and attract new clients. However, our marketing activities may not generate client awareness or increase revenues, and even if they do, any increase in revenues may not offset the expenses we incur in our marketing activities. If we fail to successfully promote and maintain our brand or increase client leads and sales opportunities, or incur substantial expenses, we may fail to attract or retain clients necessary to realize a sufficient return on our efforts, or to achieve broad client adoption of our solutions, which could have a material adverse effect on our business, financial condition and results of operations.

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

Many of our clients, including some of our largest clients, sell service contracts through their channel partners and engage our solution to help those channel partners become more effective at selling service contract renewals. In this context, the ultimate buyers of the service contracts are end customers of those channel partners, who then receive the actual services from our clients. In the event our clients' channel partners become unreceptive to our involvement in the renewals process, those channel partners could discourage our current or future clients from engaging our solution to support channel sales. This risk is compounded by the fact that large channel partners may have relationships with more than one of our clients or prospects, in which case the negative reaction of one or more of those large channel partners could impact multiple client relationships. Accordingly, with respect to those clients and prospective clients who sell service contracts through channel partners, any significant resistance to our solution by their channel partners could harm our ability to attract or retain clients, which would damage our overall business operations.

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

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

If we fail to balance our expenses with our revenue forecasts or experience significant fluctuations in our business, our results could be harmed and we may need to raise additional capital.

We expect to continue to require significant capital and may not be able to accurately forecast our revenue and operating needs. We require a significant amount of cash resources to operate our business. We plan our expense levels and investments based on estimates of future sales performance for our clients with respect to their end customers, future revenue and future end customer acquisition. If our assumptions prove incorrect, we may not be able to adjust our spending quickly enough to offset the resulting decline in growth and revenue. Consequently, we expect that our gross margins, operating margins and cash flows may fluctuate significantly on a quarterly basis, and we may need to raise additional capital in order to meet operating and capital expenditure requirements. Any decline in our client renewals or termination of our ongoing engagements may result in higher than anticipated losses in the future and shorten the time before we would need to raise additional capital. If we issue equity securities in order to raise additional funds, substantial dilution to existing stockholders may occur. If we raise cash through additional indebtedness, we may be subject to additional contractual restrictions on our business.

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

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

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Our revenue and earnings are affected by foreign currency exchange rate fluctuations.

In 2018, approximately 40% of our revenue was generated outside of the United States, as compared to 37% of our revenue in 2017. As a result of our continued focus on international markets, we expect that revenue derived from international sources will continue to represent a significant portion of our total revenue.

A portion of the sales commissions earned from our international clients is paid in foreign currencies. As a result, fluctuations in the value of these foreign currencies may make our solution more expensive or cause resulting fluctuations in cost for international clients, which could harm our business. We currently do not undertake hedging activities to manage these currency fluctuations. Even if we were to implement hedging strategies to mitigate this risk, these strategies might not eliminate our exposure to foreign exchange rate fluctuations and would involve costs and risks of their own, such as ongoing management time and expense, external costs to implement the strategies and potential accounting implications. In addition, if the effective price of the contracts we sell to end customers were to increase as a result of fluctuations in the exchange rate of the relevant currencies, demand for such contracts could fall, which in turn would reduce our revenue.

The planned exit of the United Kingdom from the European Union could adversely affect our business.

The upcoming departure of the United Kingdom from the European Union, known as Brexit, could have significant implications for our business. We have a revenue delivery center in Liverpool, United Kingdom, and Brexit has, and could continue to, create uncertainty in our employee base relating to immigration and other cross-border matters.

Brexit could lead to economic and legal uncertainty, including significant volatility in currency exchange rates, reduced customer demand for our services, and increasingly divergent laws and regulations as the United Kingdom determines which European Union laws to replace or replicate. In addition, Brexit could cause a shift or increase in data privacy regulations for data transfers between the United Kingdom and European Union. Any of these effects of Brexit, among others, could adversely affect our operations in the United Kingdom and our financial results.

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

Our services or solutions could infringe the intellectual property rights of others, impacting our ability to deploy our services or solutions with our clients. From time to time, we receive letters from other parties alleging, or inquiring about, possible breaches of their intellectual property rights. These claims could require us to cease activities, incur expensive licensing costs, or engage in costly litigation, each of which could adversely affect our business and results of operations.

In addition, we may incorporate open source software into our technology solution. The terms of many open source licenses have not been interpreted by United States or foreign courts, and there is a risk that such licenses could be construed in a manner that imposes unanticipated conditions or restrictions on our commercialization of any of our solutions that may include open source software. As a result, we will be required to analyze and monitor our use of open source software closely. As a result of the use of open source software, we could be required to seek licenses from third parties in order to develop such future products, re-engineer our products, discontinue sales of our solutions or release our software code under the terms of an open source license to the public. Given the nature of open source software, there is also a risk that third parties may assert copyright and other intellectual property infringement claims against us based on any use of such open source software. These claims could result in significant expense to us, which could harm our business.

If we fail to protect our intellectual property and proprietary rights adequately, our business could be adversely affected.

We believe that proprietary technology is essential to establishing and maintaining our leadership position. We seek to protect our intellectual property through trade secrets, copyrights, confidentiality, non-compete and nondisclosure agreements, trademarks, domain names and other measures, some of which afford only limited protection. Despite our efforts to protect our proprietary rights, unauthorized parties may attempt to copy aspects of our technology or to obtain and use information that we regard as proprietary. We cannot assure you that our means of protecting our proprietary rights will be adequate or that our competitors will not independently develop similar or superior technology or design around our intellectual property. Our failure to adequately protect our intellectual property and

proprietary rights could adversely affect our business, financial condition and results of operations.

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Interruption of operations at our data centers and revenue delivery centers could have a materially adverse effect on our business.

If we experience a temporary or permanent interruption in our operations at one or more of our data or revenue delivery centers, through natural disaster, casualty, operating malfunction, cyberattack, sabotage or other causes, we may be unable to provide the services we are contractually obligated to deliver. Failure to provide contracted services could result in contractual damages or clients' termination or renegotiation of their contracts. Although we maintain disaster recovery and business continuity plans and precautions designed to protect our company and our clients from events that could interrupt our delivery of services, there is no guarantee that such plans and precautions will be effective or that any interruption will not be prolonged. Any prolonged interruption in our ability to provide services to our clients for whom our plans and precautions fail to adequately protect us could have a material adverse effect on our business, results of operation and financial condition.

We are dependent on the continued participation and level of service of our third-party platform provider. Any failure or disruption in this service could materially and adversely affect our ability to manage our business effectively.

We rely on salesforce.com to provide the platform supporting many of our technologies and Amazon Web Services ("AWS") to support a significant portion of our data storage. If salesforce.com or AWS stops supporting our technologies or if they fail to provide a platform that consistently and adequately supports our solution, including as a result of errors or failures in their systems or events beyond their control, or refuse to provide their platforms on terms acceptable to us or at all and we are not able to find suitable alternatives, our business may be materially and adversely affected.

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

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

We may be subject to state, local and foreign taxes that could harm our business.

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

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

We may incur material restructuring charges.

We continually evaluate ways to reduce our operating expenses and adapt to changing industry and market conditions through new restructuring opportunities, including more effective utilization of our assets, workforce and operating facilities. We have recorded restructuring charges in the past and we may incur material restructuring charges in the future. The risk that we incur material restructuring charges may be heightened during economic downturns or with

expanded global operations.

We have incurred indebtedness in connection with our business and may in the future incur additional indebtedness that could limit cash flow available for our operations, limit our ability to borrow additional funds and, if we were unable to repay our debt when due, would have a material adverse effect on our business, results of operations, cash flows and financial condition.

During July 2018, we entered into a \$40.0 million senior secured revolving line of credit. As of February 27, 2019, we had no borrowings outstanding on our revolver. We may incur additional indebtedness in connection with financing acquisitions, strategic transactions or for other purposes. We are subject to the risks normally associated with debt obligations, including the risk that we will be unable to refinance our indebtedness, or that the terms of such refinancing will not be as favorable as the terms of our indebtedness.

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Our indebtedness could have a material adverse effect on our business, results of operations, cash flows and financial condition. For example, it could:

- increase our vulnerability to general adverse economic and industry conditions;
- reduce our ability to use cash to fund acquisitions, working capital and other general corporate purposes;
- make us less able to withstand competitive pressures and limit our flexibility in planning for, or reacting to, changes in our business and economic conditions;
- restrict us from exploiting business opportunities; and
- limit our ability to borrow additional funds for working capital, capital expenditures, acquisitions, execution of our business strategy or other general corporate purposes.

If we are unable to generate sufficient cash flow or otherwise obtain funds necessary to make required payments or otherwise refinance any debt that we incur, our business could suffer.

Our financial condition and results of operations could suffer if there is an impairment of goodwill.

We are required to test goodwill annually or more frequently if certain circumstances change that would more-likely-than-not indicate the carrying value of the reporting unit may not be recoverable. As of December 31, 2018, our goodwill was \$6.3 million. When the carrying value of a reporting unit's goodwill exceeds its implied fair value of goodwill, a charge to operations is recorded. This would result in incremental expenses for that period, which would reduce any earnings or increase any loss for the period in which the impairment was determined to have occurred. Declines in our level of revenues or declines in our operating margins, or sustained declines in our stock price, increase the risk that goodwill may become impaired in future periods. Our goodwill impairment analysis is sensitive to changes in key assumptions used in our analysis, such as expected future cash flows and our stock price. If the assumptions used in our analysis are not realized, it is possible that an impairment charge may need to be recorded in the future. We cannot accurately predict the amount and timing of any impairment of goodwill. However, any such impairment would have an adverse effect on our results of operations.

Risks Relating to Owning Our Common Stock and Capitalization Matters

Our results may differ significantly from any guidance that we may issue.

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

We may be unable to maintain compliance with Nasdaq Marketplace Rules which could cause our common stock to be delisted from the Nasdaq Global Select Market. This could result in the lack of a market for our common stock, cause a decrease in the value of our common stock, and adversely affect our business, financial condition and results of operations.

Under the Nasdaq Marketplace Rules our common stock must maintain a minimum price of \$1.00 per share for continued inclusion on the Nasdaq Global Select Market.

Our stock price was previously below \$1.00 on certain dates during December 2018 and February 2019 and we cannot guarantee that our stock price will remain at or above \$1.00 per share. If the price again drops below \$1.00 per share, our stock could become subject to delisting, and we may seek stockholder approval for a reverse stock split, which in turn could produce adverse effects and may not result in a long-term or permanent increase in the price of our common stock.

In addition to the minimum \$1.00 per share requirement, the Nasdaq Global Select Market has other listing requirements, including: (i) a minimum of \$50.0 million in total asset value and \$50.0 million in revenues in the latest fiscal year or in two of the last three fiscal years; (ii) a minimum of \$50.0 million in market value of listed securities, \$15.0 million in market value of publicly held securities and at least 1.1 million publicly held shares; or (iii) a minimum of \$10.0 million in stockholders' equity. As of December 31, 2018, we were in compliance with these listing requirements. However, we cannot assure you that we will be able to continue to comply with Nasdaq's listing requirements. Should we be unable to remain in compliance with these requirements, our stock could become subject to delisting.

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If our common stock is delisted, trading of the stock will most likely take place on an over-the-counter market established for unlisted securities. An investor is likely to find it less convenient to sell, or to obtain accurate quotations in seeking to buy, our common stock on an over-the-counter market, and many investors may not buy or sell our common stock due to difficulty in accessing over-the-counter markets, or due to policies preventing them from trading in securities not listed on a national exchange or other reasons. For these reasons and others, delisting would adversely affect the liquidity, trading volume and price of our common stock, causing the value of an investment in us to decrease and having an adverse effect on our business, financial condition and results of operations by limiting our ability to attract and retain qualified executives and employees and limiting our ability to raise capital. Anti-takeover provisions contained in our certificate of incorporation and bylaws, as well as provisions of Delaware law, could impair a takeover attempt.

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

- authorizing blank check preferred stock, which could be issued by our board of directors without stockholder approval, with voting, liquidation, dividend and other rights superior to our common stock;
- limiting the liability of, and providing indemnification to, our directors and officers;
- limiting the ability of our stockholders to call and bring business before special meetings and to take action by written consent in lieu of a meeting;
- requiring advance notice of stockholder proposals for business to be conducted at meetings of our stockholders and for nominations of candidates for election to our board of directors;
- controlling the procedures for the conduct and scheduling of stockholder meetings;
- providing the board of directors with the express power to postpone previously scheduled annual meetings and to cancel previously scheduled special meetings;
- limiting the determination of the number of directors on our board and the filling of vacancies or newly created seats on the board to our board of directors then in office; and
- providing that directors may be removed by stockholders only for cause.

These provisions, alone or together, could delay hostile takeovers and changes in control or changes in our management. As a Delaware corporation, we are also subject to provisions of Delaware law, including Section 203 of the Delaware General Corporation law, which limits the ability of stockholders owning in excess of 15% of our outstanding common stock to merge or combine with us.

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

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

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

Because we currently do not intend to pay dividends, stockholders will benefit from an investment in our common stock only if it appreciates in value.

We currently intend to retain our future earnings, if any, for use in the operation of our business and do not expect to pay any cash dividends in the foreseeable future on our common stock. As a result, the success of an investment in our common stock will depend upon any future appreciation in its value. There is no guarantee that our common stock will appreciate in value or even maintain the price at which stockholders have purchased their shares.

Our business or the value of our common stock could be negatively affected as a result of actions by activist stockholders.

Our company values constructive input from investors and regularly engages in dialogues with stockholders regarding strategy and performance. Our board of directors and management team are committed to acting in the best interests of all of our stockholders. There is no assurance that the actions taken by our board of directors and management in seeking to maintain constructive engagement with stockholders will be successful.

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Activist stockholders who disagree with the composition of our board of directors, our strategy, or the way our company is managed may seek to effect change through various strategies that range from private engagement to publicity campaigns, proxy contests, efforts to force transactions not supported by our board of directors, and litigation. Responding to some of these actions can be costly and time-consuming, may disrupt our operations and divert the attention of our board of directors, management, and employees. Such activities could interfere with our ability to execute our strategic plan and to attract and retain qualified executive leadership and could cause concern to our current or potential clients. The perceived uncertainty as to our future direction resulting from activist strategies could also affect the market price and volatility of our common stock.

ITEM 1B. UNRESOLVED STAFF COMMENTS

None.

ITEM 2. PROPERTIES

The table below presents the location, size and principal function of our leased global facilities. We believe our facilities are adequate to meet business operation needs for the foreseeable future.

Location	Square Footage	Region	Type of Facility
Nashville, TN, United States	120,685	NALA	Revenue Delivery Center
Denver, CO, United States	71,319	NALA	Corporate Headquarters / Revenue Delivery Center
San Francisco, CA, United States	7,215	NALA	Research and Development Center
Manila, Philippines	93,443	APJ	Revenue Delivery Center
Kuala Lumpur, Malaysia	58,985	APJ	Revenue Delivery Center
Singapore	17,626	APJ	Revenue Delivery Center
Yokohama, Japan	8,987	APJ	Revenue Delivery Center
Okinawa, Japan	2,476	APJ	Revenue Delivery Center
Dublin, Republic of Ireland	38,060	EMEA	Revenue Delivery Center
Liverpool, United Kingdom	22,575	EMEA	Revenue Delivery Center
Sofia, Bulgaria*	31,510	EMEA	Revenue Delivery Center

*An expansion lease in Sofia, Bulgaria was signed in 2018 and is expected to commence in 2019.

ITEM 3. LEGAL PROCEEDINGS

The Company is subject to various legal proceedings and claims arising in the ordinary course of our business, including the cases discussed below. Although the results of litigation and claims cannot be predicted with certainty, the Company is currently not aware of any litigation or threats of litigation in which the final outcome could have a material adverse effect on our business, operating results, financial position, or cash flows. Regardless of the outcome, litigation can have an adverse impact on the Company because of defense and settlement costs, diversion of management resources and other factors. The Company records a contingent liability when it is probable that a loss has been incurred and the amount is reasonably estimable in accordance with accounting for contingencies. As of December 31, 2018 and 2017, the Company accrued a \$3.8 million and \$1.5 million, respectively, reserve relating to our potential liability for currently pending disputes, reflected in "Other current liabilities" in the Consolidated Balance Sheets.

On August 23, 2016, the United States District Court for the Middle District of Tennessee granted conditional class certification in a lawsuit originally filed on September 21, 2015 by three former senior sales representatives. The lawsuit, Sarah Patton, et al v. ServiceSource Delaware, Inc., asserts a claim under the Fair Labor Standards Act alleging that certain non-exempt employees in our Nashville location were not paid for all hours worked and were not properly paid for overtime hours worked. The complaint also asserts claims under Tennessee state law for breach of contract and unjust enrichment. On September 28, 2018, the plaintiffs filed a motion to certify the state law breach of contract and unjust enrichment claims as a class action. A settlement of all claims was reached at mediation, and the motion for required court approval of the settlement was filed on January 24, 2019. The Company anticipates Court approval of the settlement and conclusion of the lawsuit in the coming months.

ITEM 4. MINE SAFETY DISCLOSURES

Not applicable.

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PART II

ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND
ISSUER PURCHASES OF EQUITY SECURITIES

Market Information

Our common stock is traded on the Nasdaq Global Market under the symbol "SREV."

Holders

As of February 20, 2019, there were 60 holders of record of our common stock. A substantially greater number of holders of our common stock are "street name" or beneficial holders, whose shares are held by banks, brokers and other financial institutions.

Dividends

We have never declared or paid cash dividends on our common stock. We currently intend to retain all available funds and any future earnings for use in the operation of our business and do not anticipate paying any dividends on our common stock in the foreseeable future. Any future determination to declare dividends will be made at the discretion of our board of directors and will depend on our financial condition, operating results, capital requirements, general business conditions and other factors that our board of directors may deem relevant.

Stock Performance Graph

The following graph shows a comparison of cumulative total stockholder return for our common stock, the Russell Microcap Index and the Nasdaq US Small Cap Business Support Services Index. Such returns are based on historical results and are not intended to suggest future performance. Data for the indexes assumes the reinvestment of dividends. We have never declared or paid cash dividends on our common stock nor do we anticipate paying any such cash dividends in the foreseeable future. Stockholders' returns over the indicated period are based on historical data and should not be considered indicative of future stockholder returns.

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	ServiceSource	Russell Microcap Index	NASDAQ US Small Cap Business Support Services Index
12/31/2013	\$ 100.00	\$ 100.00	\$ 100.00
12/31/2014	\$ 55.85	\$ 102.47	\$ 99.48
12/31/2015	\$ 55.01	\$ 96.03	\$ 91.22
12/31/2016	\$ 67.78	\$ 114.12	\$ 115.06
12/31/2017	\$ 36.87	\$ 127.78	\$ 125.19
12/31/2018	\$ 12.89	\$ 109.90	\$ 123.06

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ITEM 6. SELECTED FINANCIAL DATA

The following selected consolidated financial data should be read in conjunction with “Item 7. Management’s Discussion and Analysis of Financial Condition and Results of Operations” and our Consolidated Financial Statements and the related notes included in “Item 8. Financial Statements and Supplementary Data.”

	For the Year Ended December 31,				
	2018	2017	2016	2015	2014
	(in thousands, except per share amounts)				
Net revenue	\$238,340	\$239,127	\$252,887	\$252,203	\$272,180
Cost of revenue ⁽¹⁾	164,693	163,709	165,069	171,369	194,009
Gross profit	73,647	75,418	87,818	80,834	78,171
Operating expenses:					
Sales and marketing ⁽¹⁾	35,600	33,001	41,972	44,086	59,988
Research and development ⁽¹⁾	6,436	5,729	8,344	16,480	25,802
General and administrative ⁽¹⁾	47,288	53,087	52,995	46,299	47,808
Restructuring and other related costs ⁽¹⁾	209	7,308	—	3,662	3,314
Goodwill and other intangible asset impairment	—	—	—	—	25,108
Total operating expenses	89,533	99,125	103,311	110,527	162,020
Loss from operations	(15,886)	(23,707)	(15,493)	(29,693)	(83,849)
Interest and other expense, net	(6,591)	(9,886)	(8,704)	(9,316)	(11,008)
Impairment loss on cost basis equity investment	—	—	(4,500)	—	—
Gain on sale of cost basis equity investment	—	2,100	—	—	—
Impairment loss on investment securities	(1,958)	—	—	—	—
Loss before income taxes	(24,435)	(31,493)	(28,697)	(39,009)	(94,857)
Provision for income tax (expense) benefit	(450)	1,647	(3,429)	(1,584)	(482)
Net loss	\$(24,885)	\$(29,846)	\$(32,126)	\$(40,593)	\$(95,339)
Net loss per common share:					
Basic and diluted	\$(0.27)	\$(0.33)	\$(0.37)	\$(0.48)	\$(1.15)
Weighted-average common shares outstanding:					
Basic and diluted	91,636	89,234	86,318	85,417	82,872

⁽¹⁾ Reported amounts included stock-based compensation expense as follows:

	For the Year Ended December 31,				
	2018	2017	2016	2015	2014
	(in thousands)				
Cost of revenue	\$1,056	\$1,335	\$1,484	\$2,666	\$3,995
Sales and marketing	3,131	3,774	3,004	3,393	6,193
Research and development	180	149	586	1,299	2,800
General and administrative	5,234	8,425	5,678	6,029	7,911
Restructuring and other related costs	—	352	—	2,579	—
Total stock-based compensation	\$9,601	\$14,035	\$10,752	\$15,966	\$20,899

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As of December 31,
2018 2017 2016 2015 2014

(in thousands)

Consolidated Balance Sheet Data:

Cash and cash equivalents and short-term investments	\$26,535	\$188,570	\$185,573	\$208,712	\$215,382
Working capital ⁽¹⁾	\$58,265	\$72,538	\$218,585	\$236,431	\$249,590
Total assets	\$136,580	\$295,372	\$306,090	\$317,564	\$337,120
Other long-term liabilities	\$6,540	\$4,603	\$6,495	\$4,311	\$4,660
Convertible notes, net	\$—	\$144,167	\$134,775	\$126,051	\$118,004
Total stockholders' equity	\$101,833	\$112,109	\$126,936	\$147,975	\$169,347

⁽¹⁾ Working capital is defined as current assets less current liabilities.

The following table presents the calculation of adjusted EBITDA reconciled from "Net loss":

For the Year Ended December 31,
2018 2017 2016 2015 2014

(in thousands)

Net loss	\$(24,885)	\$(29,846)	\$(32,126)	\$(40,593)	\$(95,339)
Provision for income tax expense (benefit)	450	(1,647)	3,429	1,584	482
Interest and other expense, net	6,591	9,886	8,704	9,316	11,008
Depreciation and amortization	16,495	22,588	16,165	13,736	13,219
EBITDA ⁽¹⁾	(1,349)	981	(3,828)	(15,957)	(70,630)
Stock-based compensation	9,601	13,683	10,752	13,387	20,899
Amortization of contract acquisition asset costs - ASC 606 initial adoption	1,529	—	—	—	—
Gain on sale of cost basis equity investment	—	(2,100)	—	—	—
Impairment loss on investment securities	1,958	—	—	—	—
Impairment loss of cost basis equity investment	—	—	4,500	—	—
Adjustments to revenue	—	—	—	350	1,346
Acquisition related costs	—	—	—	—	728
Restructuring and other related costs	209	7,308	—	3,662	3,314
Goodwill and other intangible impairment	—	—	—	—	25,108
Litigation reserve	2,250	—	1,500	—	—
Adjusted EBITDA ⁽¹⁾	\$14,198	\$19,872	\$12,924	\$1,442	\$(19,235)

⁽¹⁾ ServiceSource believes net income (loss), as defined by GAAP, is the most appropriate financial measure of our operating performance; however, ServiceSource considers adjusted EBITDA to be a useful supplemental, non-GAAP financial measure of our operating performance. We believe adjusted EBITDA can assist investors in understanding and assessing our operating performance on a consistent basis, as it removes the impact of the Company's capital structure and other non-cash or non-recurring items from operating results and provides an additional tool to compare ServiceSource's financial results with other companies in the industry, many of which present similar non-GAAP financial measures.

EBITDA consists of net income (loss) plus provision for income tax (benefit) expense, interest and other expense, net and depreciation and amortization. Adjusted EBITDA consists of EBITDA plus non-cash stock-based compensation, amortization of contract acquisition costs related to the initial adoption of Accounting Standards Codification Topic 606, Revenue from Contracts with Customers ("ASC 606"), gain on sale of cost basis equity investment, impairment loss on investment securities, impairment loss of cost basis equity investment, adjustments to revenue, acquisition related costs, restructuring and other related costs, goodwill and other intangible impairment and litigation reserve.

This non-GAAP measure should not be considered a substitute for, or superior to, financial measures calculated in accordance with GAAP.

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ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A") should be read in conjunction with our annual Consolidated Financial Statements and notes thereto appearing elsewhere in this annual report on Form 10-K. MD&A contains forward-looking statements. See "Forward-Looking Statements" and "Item 1A. Risk Factors" for a discussion of the uncertainties, risks and assumptions associated with these statements. Actual results may differ materially from those contained in any forward-looking statements.

Overview

ServiceSource International, Inc. is a global leader in outsourced, performance-based customer success and revenue growth solutions. Through our people, processes and technology, we grow and retain revenue on behalf of our clients — some of the world's leading business-to-business companies — in more than 45 languages. Our solutions help our clients strengthen their customer relationships, drive improved customer adoption, expansion and retention and minimize churn. Our technology platform and best-practice business processes combined with our highly-trained, client-focused revenue delivery professionals and data from 20 years of operating experience enable us to provide our clients greater value for our customer success services than attained by our clients' in-house customer success teams.

Our CEO manages and allocates resources on a company-wide basis as a single segment that is focused on service offerings which integrate data, processes and cloud technologies.

Factors Affecting our Performance

Sales Cycle. We sell our integrated solution through our sales organization. At the beginning of the sales process, our quota-carrying sales representatives contact prospective clients and educate them about our offerings. Educating prospective clients about the benefits of our solutions can take time, as many of these prospects have not historically relied upon integrated solutions like ours for service revenue management, nor have they typically put out a formal request for proposal or otherwise made a decision to focus on this area. As part of our sales process, our solutions design team performs a service performance analysis of our prospect's service revenue. This includes an analysis of best practices, and benchmarks the prospect's service revenue against industry peers. Through this process, which typically takes several weeks, we are able to assess the characteristics and size of the prospect's service revenue, identify potential areas of performance improvement, and formulate our proposal for managing the prospect's service revenue. The length of our sales cycle for a new client, inclusive of the service performance analysis process and measured from our first formal discussion with the client until execution of a new client contract, is typically longer than six months and has increased in recent periods.

Implementation Cycle. After entering into an engagement with a new client, and to a lesser extent after adding an engagement with an existing client, we incur sales and marketing expenses related to the commissions owed to our sales personnel. These commissions are generally based on realized revenue that the contract delivers over time with a smaller portion based on the estimated total annual contract value. Commission amounts based on realized revenue are expensed in the period the related revenue is recognized by the Company. Upfront commissions based on estimated total annual contract value are capitalized as Contract acquisition costs and expensed ratably over the expected life of the applicable contract or five years if the contract is between the Company and one of its long-standing clients. We also make upfront investments in technology and personnel to support the engagement. These upfront commissions and investments are typically incurred one to three months before we begin generating sales and recognizing revenue. Accordingly, in a given quarter, an increase in new clients, and, to a lesser extent, an increase in engagements with existing clients, or a significant increase in the contract value associated with such new clients and engagements, will negatively impact our gross margin and operating margins until we begin to achieve anticipated sales levels associated with the new engagements, which is typically two to three quarters after we begin selling contracts on behalf of our clients.

Although we expect new client engagements to contribute to our operating profitability over time, in the initial periods of a client relationship, the near term impact on our profitability can be negatively impacted by slower-than anticipated growth in revenues for these engagements as well as the impact of the upfront costs we incur, the lower initial level of associated service sales team productivity and lack of mature data and technology integration with the

client. As a result, an increase in the mix of new clients as a percentage of total clients may initially have a negative impact on our operating results. Similarly, a decline in the ratio of new clients to total clients may positively impact our near-term operating results.

Contract Terms. A significant portion of our revenue comes from our pay-for-performance model. Under our pay-for-performance model, we earn commissions based on the value of service contracts we sell on behalf of our clients. In some cases, we earn additional performance-based commissions for exceeding pre-determined service renewal targets.

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Our new client contracts typically have an initial term between two and four years. Our contracts generally require our clients to deliver a minimum value of qualifying service revenue contracts for us to renew on their behalf during a specified period. To the extent that our clients do not meet their minimum contractual commitments over a specified period, they may be subject to fees for the shortfall. Our client contracts are cancelable on relatively short notice, subject in most cases to the payment of an early termination fee by the client. The amount of this fee is based on the length of the remaining term and value of the contract.

Merger and Acquisition Activity. Our clients, particularly those in the technology sector, participate in an active environment for mergers and acquisitions. Large technology companies have maintained active acquisition programs to increase the breadth and depth of their product and service offerings and small and mid-sized companies have combined to better compete with large technology companies. A number of our clients have merged, purchased other companies or been acquired by other companies. We expect merger and acquisition activity to continue to occur in the future.

The impact of these transactions on our business can vary. Acquisitions of other companies by our clients can provide us with the opportunity to pursue additional business to the extent the acquired company is not already one of our clients. Similarly, when a client is acquired, we may be able to use our relationship with the acquired company to build a relationship with the acquirer. In some cases, we have been able to maintain our relationship with an acquired client even where the acquiring company handles its other service contract renewals through internal resources. In other cases, however, acquirers have elected to terminate or not renew our contract with the acquired company.

Seasonality. We experience a seasonal variance in our revenue which is typically higher in the fourth quarter when many of our clients' products come up for renewal, and for the third quarter of the year which is typically lower as a result of lower or flat renewal volume corresponding to the timing of our customers' product sales particularly in the international regions. The impact of this seasonal fluctuation can be amplified if the economy as a whole is experiencing disruption or uncertainty, leading to deferral of some renewal decisions.

Basis of Presentation

Net Revenue

Substantially all of our net revenue is attributable to commissions we earn from the sale of renewals of maintenance, support and subscription agreements on behalf of our clients. We generally invoice our clients for our selling services on a monthly basis for sales commissions, and on a quarterly basis for certain performance sales commissions. We do not set the price, terms or scope of services in the service contracts with end customers and do not have any obligations related to the underlying service contracts between our clients and their end customers. We also generate revenues from selling professional services. Professional services involves providing data integration at scale with our systems and processes, combined with client data enhancement, enablement and optimization. We typically invoice our clients for professional services on a monthly basis.

Historically, we earned revenue from the sale of subscriptions to our cloud-based applications. To date, subscription revenue is a small percentage of our total revenue. We terminated most of our subscription contracts and expect revenues generated from subscriptions to be insignificant in 2019.

We generate a significant portion of our revenue from a limited number of clients. Our top ten clients accounted for 67%, 66% and 66% of our net revenue for the years ended December 31, 2018, 2017 and 2016, respectively.

The loss of revenue from any of our top clients for any reason, including the failure to renew our contracts, termination of some or all of our services, or a change of relationship with any of our key clients or their acquisition, can cause a significant decrease in our revenue.

Our business is geographically diversified. During 2018, 60% of our net revenue was earned in NALA, 25% in EMEA and 15% in APJ. Net revenue for a particular geography generally reflects commissions earned from sales of service contracts managed from our revenue delivery center in that geography. Predominantly all of the service contracts sold and managed by our revenue delivery centers relate to end customers located in the same geography. In addition, our Kuala Lumpur location is a revenue delivery center where we have centralized, for our worldwide operations, the key contract renewal processes that do not require regional expertise, such as client data management and quoting.

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Cost of Revenue and Gross Profit

Our cost of revenue includes employee compensation, technology costs, including those related to the delivery of our cloud-based technologies, and allocated overhead costs. Employee compensation includes salary, bonus, benefits and stock-based compensation for our dedicated service sales teams. Our allocated overhead includes costs for facilities, information technology and depreciation, including amortization of internal-use software associated with our selling services revenue technology platform and cloud applications. Allocated costs for facilities consist of rent, maintenance and compensation of personnel in our facilities departments. Our allocated costs for information technology include costs associated with third-party data centers where we maintain our data servers, compensation of our information technology personnel and the cost of support and maintenance contracts associated with computer hardware and software. To the extent our client base or business with our existing client base expands, we may need to hire additional service sales personnel and invest in infrastructure to support such growth. Our cost of revenue may fluctuate significantly and increase or decrease on an absolute basis and as a percentage of revenue in the near term, including for the reasons discussed under, “Factors Affecting Our Performance-Implementation Cycle.”

Operating Expenses

Sales and Marketing

Sales and marketing expenses are a significant component of our operating costs and consist primarily of compensation expenses and sales commissions for our sales and marketing staff, amortization of contract acquisition costs, allocated expenses and marketing programs and events. We sell our solutions through our global sales organization, which is organized across three geographic regions: NALA, EMEA and APJ. Our commission plans generally provide multiple payments of commissions to our sales representatives based in part on the execution of a client contract and then on a percentage of revenue recorded during the first 18 to 21 months of the contract term. Commissions paid as a percentage of recorded revenue is contingent on the sales representatives' continued employment. We generally capitalize the amounts payable upon contract execution and amortize ratably to sales and marketing expense over the estimated contract term for new clients or estimated life of the client for long-standing client relationships. Revenue based commissions are expensed to sales and marketing expense each quarter as revenue is recorded.

Research and Development

Research and development expenses consist primarily of employee compensation expense, allocated costs and the cost of third-party service providers. We focus our research and development efforts on developing new products and applications related to our technology platform. We capitalize certain expenditures related to the development and enhancement of internal-use software related to our technology platform.

General and Administrative

General and administrative expenses consist primarily of employee compensation expense for our executive, human resources, finance and legal functions and related expenses for professional fees for accounting, tax and legal services, as well as allocated expenses, which consist of depreciation, amortization of internally developed software, facility and technology costs.

Restructuring and Other Related Costs

Restructuring and other related costs consist primarily of employees' severance payments and related employee benefits, stock-based compensation related to the accelerated vesting of certain equity awards, related legal fees, asset impairment charges and charges related to leases and other contract termination costs. In February 2019, the Company announced a restructuring effort to better align its cost structure with current business and market conditions, including a headcount reduction. In connection with this restructuring effort, the Company is expected to incur additional costs in severance and other employee related costs during 2019.

Interest and Other Expense, Net

Interest and other expense, net consists of interest expense associated with our convertible notes and revolver, imputed interest from capital lease payments, interest income earned on our cash and cash equivalents and marketable securities, accretion of the debt discount, amortization of debt issuance costs and foreign exchange gains and losses. We recognize accretion of the debt discount and amortization of interest costs using the effective interest rate method.

We expect interest expense and other, net to decrease significantly due to the maturity and payoff of our \$150.0 million convertible notes in August 2018 and minimal activity expected on our revolver in 2019.

Table of Contents**Provision for Income Tax Benefit (Expense)**

We account for income taxes using an asset and liability method, which requires the recognition of taxes payable or refundable for the current year and deferred tax assets and liabilities for the expected future tax consequences of temporary differences that currently exist between the tax basis and the financial reporting basis of our taxable subsidiaries' assets and liabilities using the enacted tax rates in effect for the year in which the differences are expected to reverse. The effect of a change in tax rates on deferred tax assets and liabilities is recognized in operations in the period that includes the enactment date. The measurement of deferred tax assets is reduced, if necessary, by the amount of any tax benefits that, based on available evidence, are not expected to be realized.

We evaluate our ability to realize the tax benefits associated with deferred tax assets on a jurisdictional basis. This evaluation utilizes the framework contained in ASC 740, Income Taxes, wherein management analyzes all positive and negative evidence available at the balance sheet date to determine whether all or some portion of our deferred tax assets will not be realized. Under this guidance, a valuation allowance must be established for deferred tax assets when it is more-likely-than-not (a probability level of more than 50 percent) that they will not be realized. In assessing the realization of our deferred tax assets, we consider all available evidence, both positive and negative, and place significant emphasis on guidance contained in ASC 740, which states that "a cumulative loss in recent years is a significant piece of negative evidence that is difficult to overcome."

We account for unrecognized tax benefits using a more-likely-than-not threshold for financial statement recognition and measurement of tax positions taken or expected to be taken in a tax return. We establish reserves for tax-related uncertainties based on estimates of whether, and the extent to which, additional taxes will be due. We record an income tax liability, if any, for the difference between the benefit recognized and measured and the tax position taken or expected to be taken on our tax returns. To the extent that the assessment of such tax positions change, the change in estimate is recorded in the period in which the determination is made. The reserves are adjusted in light of changing facts and circumstances, such as the outcome of a tax audit. The provision for income taxes includes the impact of reserve provisions and changes to reserves that are considered appropriate.

Key Financial Results – Full Year Ended December 31, 2018

GAAP revenue was \$238.3 million, compared with \$239.1 million reported for the year ended December 31, 2017.

GAAP net loss was \$24.9 million or \$0.27 per diluted share, compared with GAAP net loss of \$29.8 million or \$0.33 per diluted share reported for the year ended December 31, 2017.

Ended the year with \$27.8 million of cash and cash equivalents and restricted cash and no borrowings under the Company's \$40.0 million revolving line of credit.

Results of Operations

For the Year Ended December 31, 2018 Compared to the Year Ended December 31, 2017

Net Revenue, Cost of Revenue and Gross Profit

	For the Year Ended December 31, 2018			2017				
	Amount	% of Net Revenue		Amount	% of Net Revenue			
	(in thousands)			(in thousands)			(in thousands)	
Net revenue	\$238,340	100 %		\$239,127	100 %		\$ (787)	— %
Cost of revenue	164,693	69 %		163,709	68 %		984	1 %
Gross profit	\$73,647	31 %		\$75,418	32 %		\$ (1,771)	(2)%

Net revenue decreased by \$0.8 million for the year ended December 31, 2018 compared to the same period in 2017, primarily due to unexpected client churn and lower end user demand at several clients, offset by expansion and increased production within existing clients.

Cost of revenue increased \$1.0 million, or 1%, for the year ended December 31, 2018 compared to the same period in 2017, primarily due to the following:

•

\$4.9 million increase in employee related costs primarily due to operational improvements in managed services, new clients and expansion of business with existing clients resulting in an increase in headcount in lower costs locations; \$1.3 million increase in facility related costs primarily due to increased headcount; and

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- \$0.8 million increase in information technology costs; partially offset by
- \$5.4 million decrease in depreciation and amortization expense primarily due to intangible assets fully depreciated as of January 2018 and internally developed software fully depreciated as of July 2018; and
- \$0.5 million decrease in professional fees.

Operating Expenses

	For the Year Ended December 31,							
	2018			2017				
	Amount	% of Net		Amount	% of Net		\$ Change	% Change
	(in thousands)	Revenue		(in thousands)	Revenue		(in thousands)	
Operating expenses:								
Sales and marketing	\$35,600	15	%	\$33,001	14	%	\$ 2,599	8 %
Research and development	6,436	3	%	5,729	2	%	707	12 %
General and administrative	47,288	20	%	53,087	22	%	(5,799)	(11)%
Restructuring and other related costs	209	—	%	7,308	3	%	(7,099)	(97)%
Total operating expenses	\$89,533	38	%	\$99,125	41	%	\$ (9,592)	(10)%

Sales and Marketing

Sales and marketing expense increased \$2.6 million, or 8%, for the year ended December 31, 2018 compared to the same period in 2017, primarily due to the following:

- \$1.8 million increase in amortization of contract acquisition costs due to the adoption of ASC 606, see Notes to the Consolidated Financial Statements “Note 2 - Summary of Significant Accounting Policies” for additional information;
- \$1.3 million increase in employee related costs primarily due to increased headcount and rebuilding of marketing team;
- \$0.3 million increase in facility related costs primarily due to increased headcount; and
- \$0.2 million increase in information technology costs; partially offset by

\$0.5 million decrease in depreciation and amortization expense primarily due to intangible assets being fully depreciated as of January 2018; and

\$0.4 million decrease in marketing costs due to re-branding and website updates during 2017 with minimal costs during 2018.

Research and Development

Research and development expense increased \$0.7 million, or 12%, for the year ended December 31, 2018 compared to the same period in 2017, primarily due to the following:

- \$1.1 million increase in information technology costs; and
- \$0.5 million increase in employee related costs primarily due to a reduction in capitalizable costs from the migration from Renew OnDemand to PRISM; partially offset by
- \$0.5 million decrease in facility related costs primarily driven by downsizing the San Francisco office; and
- \$0.2 million decrease in professional fees.

Internal-use software development capitalization decreased \$1.5 million for the year ended December 31, 2018 compared to the same period in 2017, primarily due to the migration from our Renew OnDemand platform to PRISM. We expect to continue to invest in our technology platforms to support our services offering and thus capitalizing internal-use software costs in the future. However, the amount capitalized will depend on the future level of expenditures on our technology platforms.

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General and Administrative

General and administrative expense decreased \$5.8 million, or 11%, for the year ended December 31, 2018 compared to the same period in 2017, primarily due to the following:

\$7.1 million decrease in employee compensation costs primarily due to change in executive management and decrease in bonus due to lower revenue attainment; and

\$0.8 million decrease in facility related costs primarily related to increased headcount in cost of revenues and sales and marketing; partially offset by

\$2.3 million increase in legal reserves.

Restructuring and Other Related Costs

Restructuring and other related costs decreased \$7.1 million, or 97%, for the year ended December 31, 2018 compared to the same period in 2017 primarily due to the restructuring of the Company in May 2017.

Other Expenses

	For the Year Ended December 31,				\$ Change	% Change
	2018	% of Net Revenue	2017	% of Net Revenue		
	Amount (in thousands)		Amount (in thousands)		(in thousands)	
Interest expense	\$ (7,396)	(3)%	\$ (11,683)	(5)%	\$ (4,287)	(37)%
Other expense, net	\$ 805	— %	\$ 1,797	1 %	\$ (992)	(55)%
Gain on sale of cost basis equity investment	\$ —	— %	\$ 2,100	1 %	\$ (2,100)	(100)%
Impairment loss on investment securities	\$ (1,958)	(1)%	\$ —	— %	\$ (1,958)	100 %

Interest expense decreased \$4.3 million, or 37%, for the year ended December 31, 2018 compared to the same period in 2017 primarily due to the repayment of our \$150.0 million convertible notes in August 2018.

Other expense, net decreased \$1.0 million, or 55%, for the year ended December 31, 2018 compared to the same period in 2017 primarily due a decrease in interest income earned on our short-term investments and foreign currency fluctuations.

During 2017, we sold our equity investment in a private company that we fully impaired in 2016 for proceeds of \$2.1 million and recorded the proceeds as a gain.

During 2018, we determined to liquidate the majority of our investment securities during the first half of 2018 to have sufficient cash on hand to repay our \$150.0 million convertible notes due August 1, 2018. Based on our decision to sell these investment securities, we determined an other-than-temporary impairment occurred as of March 31, 2018. Consequently, a \$2.0 million impairment loss was recorded in our Consolidated Statement of Operations for the year ended December 31, 2018.

Income Tax Provision

	For the Year Ended December 31,				\$ Change	% Change
	2018	% of Net Revenue	2017	% of Net Revenue		
	Amount (in thousands)		Amount (in thousands)		(in thousands)	
Provision for income tax (expense) benefit	\$ (450)	—%	\$ 1,647	1 %	\$ (2,097)	*

* Not considered meaningful.

For the year ended December 31, 2018, we recorded tax expense of \$0.5 million. The tax expense resulted primarily from profitable jurisdictions where no valuation allowance has been provided. Income tax expense increased \$2.1 million for the year ended December 31, 2018 compared to 2017, due to an increase in profitable operations in certain U.S. and foreign jurisdictions as well as no additional release of valuation allowance. As of December 31, 2018, we recorded a full valuation allowance on our state deferred tax assets. No benefit was provided for losses incurred in

U.S., Ireland and Singapore because those losses are offset by a full valuation allowance.

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For the year ended December 31, 2017, we recorded a tax benefit of \$1.6 million. This primarily represents a \$2.0 million income tax benefit related to the remeasurement of our indefinite-lived intangible deferred tax liability and release of our valuation allowance for certain net operating loss provisions as enacted under the Tax Cuts and Jobs Act. We also recorded \$0.4 million of federal, foreign and state income tax expense. No benefit was otherwise provided for losses incurred in U.S. and Singapore because these losses are offset by a valuation allowance.

For the Year Ended December 31, 2017 Compared to the Year Ended December 31, 2016

Net Revenue, Cost of Revenue and Gross Profit

	For the Year Ended December 31, 2017			2016			\$ Change	% Change
	Amount	% of Net Revenue		Amount	% of Net Revenue			
	(in thousands)			(in thousands)				
Net revenue	\$239,127	100 %		\$252,887	100 %		\$ (13,760)	(5)%
Cost of revenue	163,709	68 %		165,069	65 %		(1,360)	(1)%
Gross profit	\$75,418	32 %		\$87,818	35 %		\$ (12,400)	(14)%

Net revenue decreased by \$13.8 million, or 5%, for the year ended December 31, 2017 compared to the same period in 2016, due to contractions and lower production with certain existing clients and the bankruptcy of one of our top 10 clients, partially offset by production related to expansion of business with our existing client base and new business in 2017.

Cost of revenue decreased \$1.4 million, or 1%, for the year ended December 31, 2017 compared to the same period in 2016, primarily due to the following:

\$4.3 million decrease in employee related costs primarily due to operational improvements in our business that resulted in a reduction in headcount, increased productivity from our revenue generating employees and shifting headcount to lower cost locations;

\$1.6 million decrease in professional fees; and

\$1.2 million decrease in information technology costs; partially offset by

\$4.3 million increase in depreciation and amortization expense; and

\$1.2 million increase in facility related costs.

Operating Expenses

	For the Year Ended December 31, 2017			2016			\$ Change	% Change
	Amount	% of Net Revenue		Amount	% of Net Revenue			
	(in thousands)			(in thousands)				
Operating expenses:								
Sales and marketing	\$33,001	14 %		\$41,972	17 %		\$ (8,971)	(21)%
Research and development	5,729	2 %		8,344	3 %		(2,615)	(31)%
General and administrative	53,087	22 %		52,995	21 %		92	— %
Restructuring and other related costs	7,308	3 %		—	— %		7,308	100 %
Total operating expenses	\$99,125	41 %		\$103,311	41 %		\$ (4,186)	(4)%

Sales and Marketing

Sales and marketing expense decreased \$9.0 million, or 21%, for the year ended December 31, 2017 compared to the same period in 2016, primarily due to the following:

\$8.2 million decrease in employee related costs primarily due to lower headcount resulting from our efforts to better align our cost structure; and

\$0.4 million decrease in facility related costs.

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Research and Development

Research and development expense decreased \$2.6 million, or 31%, for the year ended December 31, 2017 compared to the same period in 2016, primarily due our efforts to reduce research and development spend as follows:

\$4.2 million decrease in employee related costs associated with a decrease in headcount; partially offset by \$1.8 million increase in professional fees.

Internal-use software development capitalization decreased \$0.5 million for the year ended December 31, 2017 compared to the same period in 2016, primarily due to the migration from our Renew OnDemand platform to PRISM.

General and Administrative

General and administrative expense increased \$0.1 million for the year ended December 31, 2017 compared to the same period in 2016, primarily due to the following:

\$2.1 million increase in depreciation and amortization expense;

\$1.0 million increase in employee related costs primarily related to performance-based restricted stock awards issued during 2016 and 2017, offset by decreases due to shifting headcount to lower cost locations; and

\$0.7 million increase in information technology spend; partially offset by

\$1.5 million decrease due to a non-recurring legal reserve recorded during 2016;

\$1.2 million decrease in professional fees; and

\$1.1 million decrease in rent and facilities costs driven primarily by downsizing the San Francisco office.

Restructuring and Other Related Costs

Restructuring and other related costs increased \$7.3 million, or 100%, for the year ended December 31, 2017 compared to the same period in 2016 due to the restructuring of the Company in May 2017.

Other Expenses

	For the Year Ended December 31,					
	2017		2016		\$ Change	% Change
	Amount	% of Net Revenue	Amount	% of Net Revenue		
	(in thousands)		(in thousands)		(in thousands)	
Interest expense	\$(11,683)	(5)%	\$(11,030)	(4)%	\$ 653	6 %
Other expense, net	\$1,797	1 %	\$2,326	1 %	\$ (529)	(23)%
Impairment loss on cost basis equity investment	\$—	— %	\$(4,500)	(2)%	\$ 4,500	(100)%
Gain on sale of cost basis equity investment	\$2,100	1 %	\$—	— %	\$ 2,100	100 %
Interest expense increased \$0.7 million, or 6%, for the year ended December 31, 2017 compared to the same period in 2016 due to the accretion of the debt discount related to our convertible notes issued in August 2013.						
Other expense, net decreased \$0.5 million, or 23%, for the year ended December 31, 2017 compared to the same period in 2016 primarily due to foreign currency fluctuations.						
During the year ended December 31, 2016, we fully impaired our 2013 cost basis equity investment due to an unfavorable declining financial performance, growth trends and future liquidity needs of the investment and recorded a \$4.5 million impairment. During the year ended December 31, 2017, we sold our equity investment that we fully impaired in 2016 for proceeds of \$2.1 million and recorded the proceeds as a gain.						

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Income Tax Provision

	For the Year Ended December 31,			% of Net Revenue	\$ Change	% Change
	2017		2016			
	Amount		Amount			
	(in thousands)		(in thousands)		(in thousands)	
Provision for income tax benefit (expense)	\$1,647					
INCOME BEFORE EXTRAORDINARY ITEM	814,027	900,769	548,150			
Extraordinary item, net of income and social contribution taxes (note 13(b))	(35,122)	(35,122)	(35,122)			
NET INCOME	778,905	865,647	513,028			
Earnings per thousand shares outstanding at year end in R\$	27.35	30.40	18.01			

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

COMPANHIA DE SANEAMENTO BÁSICO DO ESTADO DE SÃO PAULO - SABESP**STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY**

FOR THE YEARS ENDED DECEMBER 31, 2006, 2005 AND 2004

(In thousands of Brazilian reais - R\$)

	Paid in	Capital	Revaluation	Profit reserves	Investment	Retained	
	capital	reserve	reserve	Legal		earnings	Total
BALANCES AS OF JANUARY 1, 2004	3,403,688	50,739	2,723,720	146,340	1,252,456	-	7,576,943
Donations		14,552					14,552
Realization of revaluation reserve			(104,500)			104,500	-
Net income						513,028	513,028
Allocation of income:							
Legal reserve				25,651		(25,651)	-
Interest on shareholders equity						(152,935)	(152,935)
Investment reserve					438,942	(438,942)	-
BALANCES AS OF DECEMBER 31, 2004	3,403,688	65,291	2,619,220	171,991	1,691,398	-	7,951,588
Donations (note 16 (d))		13,529					13,529
Realization of revaluation reserve (note 8 (h))			(89,449)			89,449	-
Net income						865,647	865,647
Allocation of income:							
Legal reserve (note 16 (c))				43,282		(43,282)	-
Interest on shareholders equity (note 16 (c))						(348,216)	(348,216)
Investment reserve (note 16 (e))					563,598	(563,598)	-
BALANCES AS OF	3,403,688	78,820	2,529,771	215,273	2,254,996	-	8,482,548

**DECEMBER 31,
2005**

Donations (note 16 (d))	27,870						27,870
Realization of revaluation reserve (note 8 (h))		(102,272)			102,272		-
Net income					778,905		778,905
Allocation of income:							
Legal reserve (note 16 (c))			38,946		(38,946)		-
Interest on shareholders equity (note 16 (c))					(270,841)		(270,841)
Investment reserve (note 16 (e))					571,390	(571,390)	-
BALANCES AS OF							
DECEMBER 31,							
2006	3,403,688	106,690	2,427,499	254,219	2,826,386	-	9,018,482

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

COMPANHIA DE SANEAMENTO BÁSICO DO ESTADO DE SÃO PAULO - SABESP**STATEMENTS OF CHANGES IN FINANCIAL POSITION**

FOR THE YEARS ENDED DECEMBER 31, 2006, 2005 AND 2004

(In thousands of Brazilian reais - R\$)

	2006	2005	2004
SOURCES OF FUNDS			
From operations:			
Net income	778,905	865,647	513,028
Items not affecting working capital			
Bad debt expense Long term accounts receivable	102,025	137,639	76,870
Depreciation and amortization	642,171	595,981	598,911
Investments write-off	20	4,360	-
Write-off of property, plant and equipment	54,350	19,051	34,616
Write-off of deferred assets	5,195	6,700	-
Monetary variations on long-term items	(11,521)	(19,597)	(38,548)
Reversal of provision for losses with escrow deposits, net	(4,421)	-	-
Provisions for contingencies	75,450	119,577	75,660
Other provisions	7,504	-	-
Provision for pension obligation	44,654	54,382	76,636
Interests and monetary and foreign exchange variation on non current liabilities:			
Loans and financing	15,733	(143,210)	8,656
Taxes payable	15,151	21,761	25,018
Deferred income and social contribution taxes:			
In long-term assets	(43,834)	(41,549)	(34,467)
In long-term liabilities	13,458	3,388	8,938
Total from operations	1,694,840	1,624,130	1,345,318
From third parties:			
Transfers from non-current assets to current assets	394,738	328,548	278,700
Increase in non current liabilities:			
Loans and financings funding	706,774	1,153,479	780,722
Other increases	9,306	-	12,226
Increase in property, plant and equipment by donations work aid	27,870	13,529	14,552
Total from third parties	1,138,688	1,495,556	1,086,200
Decrease in working capital	145,532	-	356,265
Total sources	2,979,060	3,119,686	2,787,783
USES OF FUNDS			
Increase in long-term assets	606,197	504,482	495,807
Capitalized amounts property, plant and equipment	22,118	24,417	18,225

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Decrease in non current liabilities	-	58,028	-
In non current assets			
Property, plant and equipment	892,318	673,489	575,079
Intangible	12,630	4,748	25,824
Deferred charges	2,789	106	444
In non current liabilities			
Transfers from non current liabilities to current liabilities:			
Loans and financing	858,532	634,487	1,484,575
Taxes and contributions	40,824	37,986	34,894
Anticipated settlement of loans and financings	272,811	-	
Interest on shareholders' equity	270,841	348,216	152,935
Increase in working capital	-	833,727	-
Total uses	2,979,060	3,119,686	2,787,783
Current assets			
At end of year	1,919,032	1,725,386	1,229,790
At beginning of year	1,725,386	1,229,790	1,217,165
Variation in current assets	193,646	495,596	12,625
Current liabilities			
At end of year	2,101,936	1,762,758	2,100,889
At beginning of year	1,762,758	2,100,889	1,731,999

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Variation in current liabilities	339,178	(338,131)	368,890
Increase (decrease) in working capital	(145,532)	833,727	(356,265)

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COMPANHIA DE SANEAMENTO BÁSICO DO ESTADO DE SÃO PAULO SABESP**STATEMENTS OF CHANGES IN FINANCIAL POSITION**

FOR THE YEARS ENDED DECEMBER 31, 2006, 2005 AND 2004

(In thousands of Brazilian reais - R\$)

	2006	2005	2004
SUMMARY			
SOURCES			
From operations	1,694,840	1,624,130	1,345,318
From third parties	1,138,688	1,495,556	1,086,200
Decrease in working capital	145,532	-	356,265
Total sources	2,979,060	3,119,686	2,787,783
USES			
Increase in non current assets	606,197	504,482	495,807
Capitalized amounts property, plant and equipment	22,118	24,417	18,225
Decrease in non current liabilities	-	58,028	-
In property, plant and equipment, deferred assets and intangible	907,737	678,343	601,347
Transfers from non current liabilities to current liabilities	899,356	672,473	1,519,469
Anticipated settlement of loans and financings	272,811	-	-
Shareholders - Interests on shareholders equity	270,841	348,216	152,935
Increase in working capital	-	833,727	-
TOTAL USES	2,979,060	3,119,686	2,787,783

For 2006 the Company has chosen to enhance the model of its Statements of Change in Financial Position, presenting the increase in working capital as uses and the decrease in working capital as sources.

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

COMPANHIA DE SANEAMENTO BÁSICO DO ESTADO DE SÃO PAULO - SABESP

NOTES TO THE FINANCIAL STATEMENTS

AS OF AND FOR THE YEARS ENDED DECEMBER 31, 2006, 2005 AND 2004

(Amounts in thousands of Brazilian reais-R\$, unless otherwise stated)

1. OPERATIONS

Companhia de Saneamento Básico do Estado de São Paulo - SABESP (the Company) is engaged in the operation of public water and sewage systems in the State of São Paulo, Brazil, providing water and sewage services to a broad range of residential, commercial, industrial and government customers. The Company also provides water on a wholesale basis to certain municipalities in the São Paulo Metropolitan Region that do not have water production systems.

With the enactment of Law 12,292 on March 2, 2006 we became authorized to provide water and sewage services outside the State of São Paulo, including in other countries, either directly or through national or international consortia. We may also have equity participation in other state or mixed-capital companies, and establish subsidiaries.

The Company's shares are listed on the São Paulo Stock Exchange (BOVESPA) in the New Market segment since April, 2002, and on the New York Stock Exchange - NYSE, in the form of ADRs (American Depositary Receipts) since May, 2002.

The Company provides water and sewage services in 367 municipalities in the State of São Paulo, nearly all of which are through concessions granted by the municipalities, most of them initially contracted for a 30-years term. The 120 (one hundred twenty) concession contracts that expired until December 31, 2006 are in process of negotiation. In 2007, 53 (fifty three) contracts are going to expire, 150 (one hundred fifty) contracts between 2008 and 2034 and the remaining without determined term. Management expects that the referred concessions will be renewed or extended, thus there will not be a discontinuity of the water supply and sewage collection. The net book value of property, plant and equipment items relating to the municipalities where the concessions are under negotiation or will expire in 2007 totals R\$ 1.94 billion, and the net revenue for the year ended December 31, 2006 totals R\$ 796 million in relation to these concessions.

The Company does not hold a formal concession to provide water and sewage services in the City of São Paulo, which accounts for 56,8% of the sales and services rendered. In Santos, a municipality located in the Santos Coastal Area, which also has a significant population, the Company operates under a public deed of authorization, like in some other municipalities in the Santos Coastal Area and in the Ribeira Valley, where the Company started operating after the merger of companies that formed SABESP.

On January 5, 2007 Law 11,445 was enacted establishing the regulatory framework of basic sanitation, with the national guidelines and the fundamental principles to the rendering of services, like the social control, the transparency, the command integration of the sanitation infrastructures, the management of hydric resources, as well as the command for the articulation of the industry with the public policies of urban and regional development, housing, combat and irradiation of poverty, promotion of health and environmental protection, among other related ones. The regulatory framework seeks also the improvement of life quality with efficiency and the economic sustainability, allowing the adoption of gradual and progressive solutions coherent to the user's payment capacity.

As benefits to the Company, the law:

- Clarifies the conditions for the transitory of the services, changing article 42 of the Concessions Act to determine to the Conceding Power to perform evaluations, surveys and payment of indemnification prior to

the reversal of assets, a validity condition to the subsequent municipal acts;

- Significantly reduces the possibility of success in the judicial measures adopted for the resume of services in a sudden way and without indemnification;

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COMPANHIA DE SANEAMENTO BÁSICO DO ESTADO DE SÃO PAULO - SABESP

NOTES TO THE FINANCIAL STATEMENTS

AS OF AND FOR THE YEARS ENDED DECEMBER 31, 2006, 2005 AND 2004

(Amounts in thousands of Brazilian reais-R\$, unless otherwise stated)

- Aims the improvement of the achievement of public interests related to the environment and it favors the state planning of the services without disregarding the local peculiarities, considering the need of the Municipalities to present sanitation plans, compatible with the plans of the hydrographic basins; and
- Imposes the indication of the regulating entity and the publishing of regulatory rules that allow more clarity and efficiency in the inspection of services, as well as the providing itself, safeguarding and compatibilizing the different interests of the customer and the contracting parties.

In general, the Company does not face any competition in the municipalities in which it provides water and sewage services, and management believes that in those municipalities the Company has an exclusive right to provide such services.

All information about the concession area, number of municipalities, volume of water and sewage and other related data disclosed in this report that do not arise from the accounting and/or financial statements are not examined by the independent auditors.

2. PRESENTATION OF THE FINANCIAL STATEMENTS

The Company's statutory financial statements, which are used as the basis for determining income taxes and mandatory minimum dividend calculations, have been prepared in accordance with accounting practices adopted in Brazil, which are based on the Brazilian Corporate Law (Law No. 6,404/76, as amended), the rules and regulations of the Brazilian Securities Commission ("CVM") and the accounting standards issued by the Brazilian Institute of Independent Auditors (IBRACON), collectively referred to hereinafter as Corporate Law or BR CL. The financial statements prepared in accordance with Corporate Law have not been indexed for inflation after 1995.

(a) Inflation accounting under BR CL

BR CL provided a simplified methodology for accounting for the effects of inflation through 1995. This method consisted of restating permanent assets (property, plant and equipment, investments and deferred charges) and shareholders' equity accounts using indices mandated by the Brazilian Federal Government. The net effect of these restatements was credited or charged to the statement of income.

(b) Presentation of financial statements

To facilitate an understanding of Brazilian accounting practices, the presentation of the financial statements has been adapted from the financial statements filed for Brazilian legal and regulatory purposes. In addition, certain terminology changes have been made and the notes to the financial statements have been expanded to conform them more closely to reporting practices prevailing in the United States of America. All amounts are presented in Brazilian currency (real or reais), unless otherwise indicated.

These financial statements include the modifications introduced by the following accounting normative rules: (i) Accounting Rules and Procedures 27 (NPC 27 - Presentation and Disclosure), issued by the Brazilian Institute of Accountants - Ibracon, on October 3, 2005, approved by the CVM Resolution n. 488, on the same date, and (ii) NPC 22 - Provisions, Liabilities, Contingent Liabilities and Assets, issued by Ibracon, on October 3, 2005, approved by the CVM Resolution n. 489, on the same date. In the financial statements referring to the year ended December 31, 2005,

presented for comparative purposes, some reclassifications have been made in order to conform them to the mentioned resolutions, and to allow users the comparability to the current period. The main changes resulting from the application of these resolutions were the following:

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COMPANHIA DE SANEAMENTO BÁSICO DO ESTADO DE SÃO PAULO - SABESP

NOTES TO THE FINANCIAL STATEMENTS

AS OF AND FOR THE YEARS ENDED DECEMBER 31, 2006, 2005 AND 2004

(Amounts in thousands of Brazilian reais-R\$, unless otherwise stated)

- Presentation of the group Non-Current in assets and liabilities,
- Presentation of the account Intangible classified in the group Non current assets , and
- Reclassification of escrow deposits, previously classified in assets, to liabilities, as a reduction of the account provision for contingencies , where applicable.

The financial statements for the year ended December 31, 2005 were reclassified for better presentation and comparability maintenance, as well as the respective impact to the Statement of Changes in Financial Position, cash flow and value added statement, when applicable, as described below:

- Previously classified as escrow deposits as non-current assets, the amount of R\$ 4,069 was classified as a reduction of the provisions for contingencies in current liabilities and provision for contingencies in non-current liabilities, in the amounts of R\$ 3,037 and R\$ 1,032, respectively.
- Previously classified as accounts receivable from private customers, the amount of R\$ 126,151 was reclassified to the account transactions with related parties.
- Refundable amounts previously classified as other liabilities, in non-current liabilities, in the amount of R\$ 73,829 were reclassified to the account other current liabilities as current liabilities.
- Taxes recoverable in the amount of R\$ 853, previously classified in other accounts receivable in current assets, were reclassified to the account taxes recoverable in current assets.
- Services received, previously classified as other current liabilities in current liabilities, in the amount of R\$ 107,660, were reclassified to the account services received in current liabilities.
- Previously classified as costs of sales and services provided, the amount of R\$ 14,046 was reclassified to administrative expenses.
- Previously classified as selling expenses, the amount of R\$ 32 was reclassified to administrative expenses.

3. SIGNIFICANT ACCOUNTING PRACTICES

The Company's accounting practices, which are based on the accrual concept, comply with the Corporate Law but differ in certain significant respects from accounting principles generally accepted in the United States of America (US GAAP). See Note 23 for further discussion of the differences between BR CL and US GAAP and the reconciliation of shareholders' equity and net income between BR CL and US GAAP. Additional disclosure has been included in the notes to the financial statements to comply with the regulations of the U.S. Securities and Exchange Commission (the SEC) for foreign registrants.

(a) Revenues from sales and services

Revenues from water and sewage services are recognized as water is consumed or as services are provided. Revenues from water and sewer services rendered, but not billed, are recorded as unbilled customer accounts receivable based on monthly estimates, in order to match such revenue with costs incurred.

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In the fiscal year ended December 31, 2004, revenue was recorded net of customer discounts relating to the Program for Consumption Reduction Incentive Program (see Note 19).

(b) Marketing costs

Marketing costs are generally recorded in administrative expenses. Marketing costs were R\$ 11,895, R\$ 17,861 and R\$31,615 for the years ended on December 31, 2006, 2005 and 2004, respectively. No marketing costs were deferred at December 31, 2006, 2005 and 2004.

(c) Financial income and expenses

Financial income and expense are primarily comprised of interest, monetary and exchange variations on loans and financing, contingencies, accounts receivable and financial investments, and are calculated and reported on the accrual basis of accounting.

(d) Income tax and social contribution

Income and social contribution taxes (a federally mandated tax based on income) are accrued on taxable results.

Income tax is calculated at the rate of 15%, plus a 10% surtax, and social contribution at the rate of 9%. Those rates are reported on an accrual basis.

Deferred taxes are calculated based on taxable or deductible amounts in future years and are recognized to the extent that realization is believed to be probable.

As permitted by the CVM, the Company opted not to recognize the deferred income and social contribution taxes on the revaluation reserve of property, plant and equipment recorded up to 1991.

(e) Other income and expenses

Other income and expenses are recorded on an accrual basis.

(f) Cash and cash equivalents

Cash and cash equivalents comprise primarily bank deposits and financial investments and are carried at cost plus accrued interest, if applicable. Financial investments denominated in Reais have a ready market, and are mostly represented by Bank Deposit Certificates - CDB's in 2006 and by Financial Investment Funds - FIF's in 2005 and 2004. The Company is required by law to invest excess cash with financial institutions controlled by the State Government (see note 6).

(g) Customer accounts receivable and allowance for doubtful accounts

Customer accounts receivable generally do not accrue interest or indexation charges or penalties, except for refinanced agreements.

The Company records an allowance for doubtful accounts for receivable balances in an amount that is deemed by management to be sufficient to cover probable losses in accounts receivable, based on an aging analysis of receipts, taking into consideration the expected recovery in the different categories of customers accounts. Amounts in excess of R\$ 5 and overdue for more than 360 days and in excess of R\$ 30 and overdue for more than 360 days, which are under judicial collection proceedings, are provisioned. Accounts receivable balances under R\$ 5 and overdue more than 180 days are written off through a direct charge to income.

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The Company does not record allowance for doubtful accounts for any amounts due to it by the State Government or entities controlled by the State Government, since it does not expect to incur in losses from such balances.

(h) Inventories

Inventories of materials used in operations and in the maintenance of the Company's water and sewage systems are stated at lower of average acquisition cost or realizable value and are classified in current assets. Inventories for capital projects are classified under property, plant and equipment and are stated at the average acquisition cost.

(i) Other current assets and long-term receivables

Other current assets and long-term receivables are stated at the lower of acquisition cost or realization value, plus accrued interest, when applicable.

(j) Property, plant & equipment

Property, plant and equipment are generally stated at amounts established by independent technical appraisals, plus price-level restatements from the date of the appraisals to 1995. Revaluation increments arising from revaluing assets to appraised values are recorded in the revaluation reserve component of shareholders' equity and subsequently transferred from the reserve to retained earnings as the related assets are depreciated, sold or upon disposal. The price-level restatement adjustments were based on official inflation indices published by the federal government. The Company believes that the distortion caused by indices which understated the independently measured inflation rate have been mitigated by recording revaluation increments.

The revaluation of property, plant and equipment items, carried out in two separate stages in 1990 and 1991, was based on an appraisal report issued by independent experts. The referred revaluation was recorded with a corresponding credit to the Revaluation Reserve account in Shareholder's Equity, and is realized through depreciation, sale, and disposal of the respective assets, with a corresponding entry to Retained Earnings.

Contributions of property, plant and equipment by third parties and from government entities (such as property owners) to allow the Company to supply water and sewage services are recorded as a capital reserve.

Construction-in-progress is recorded at cost and is primarily related to construction projects under contract with third parties. For long-term projects, the Company capitalizes these projects once the Company's engineering department approves that the project milestones have been achieved and the Company takes delivery of the assets.

Depreciation

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Depreciation of property, plant and equipment, is recorded using the straight-line method based on the estimated useful lives of the underlying assets. The principal depreciation rates are detailed in Note 8.

Capitalization of interest

Consistent with the requirements of accounting regulations for Brazilian utility companies, up to 1985, interest was capitalized at 12% per annum on construction-in-progress. Interest capitalized which exceeded interest expense on loans obtained to finance construction-in-progress was recorded in a capital reserve directly in shareholders' equity. Up to 1995, BR CL did not require the capitalization of interest costs incurred during the construction period as part of the cost of the related property, plant and equipment. However, as permitted by the Brazilian Water and Sewage Plan (Plano Nacional de Saneamento Básico - PLANASA), the Company capitalized interest on construction in progress through 1988. No interest was capitalized from 1989 to 1995. Interest was again capitalized beginning in 1996, following changes in the CVM requirements in 1996. Beginning in 1999, the Company has capitalized indexation charges on the real - denominated loans and financing and the foreign exchange effects on foreign currency loans and financing. The Company capitalizes interest incurred on borrowings to the extent that borrowings do not exceed construction-in-progress, which is recorded as a reduction of interest expense.

Interest capitalized is depreciated with the cost of the asset, once the related asset becomes operational. Through December 31, 1998, but not thereafter, such depreciation of capitalized interest was deductible for purposes of determining taxes on income.

Repairs and maintenance

Improvements to existing property are capitalized, while costs of general maintenance and repairs are expensed as incurred. Materials allocated to specific projects are added to construction-in-progress.

Impairment

The Company reviews long-lived assets, primarily buildings and water and sewage systems, including property, plant and equipment and concession assets, to be held and used in the business, for the purpose of determining and measuring impairment on a recurring basis or when events or changes in circumstances indicate that the carrying value of an asset or group of assets may not be recoverable. The Company assesses impairment on the basis of the projected recovery of depreciation charges through results of operations. The carrying value of assets or groups of assets is written down to realizable value if and when appropriate.

(k) Concessions

Beginning in 1999, acquisitions of concession assets and concession rights from third parties have been accounted for at fair values, as determined in technical appraisal reports. Accordingly, the purchase price, plus direct costs of acquisition, is allocated to assets acquired and liabilities assumed based upon their estimated fair values at the date of acquisition. These concessions are recorded as concession assets acquired, included as intangible assets in the balance sheets.

Concession rights are amortized on a straight-line basis over the estimated future periods to be benefited, not to exceed the contractual term of the concession. The straight-line method of depreciation is modified, when applicable, to avoid the backloading of charges in later years by estimating future disbursement commitments to meet the Company's concession obligations.

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(l) Deferred Assets

Deferred charges are comprised primarily of deferred project costs and technical studies, which are being amortized using the straight-line method over 5 years from the date when benefits start to be generated.

(m) Loans and Financing

Loans and financing are adjusted by indexation charges and foreign exchange variations and include accruals for related interest expenses up to closing date. Loans and financing denominated in foreign currencies are translated to reais using the exchange rate in effect at the balance sheet date. The resulting foreign currency exchange adjustments are recognized as incurred in financial income (expense), net.

(n) Salaries and payroll charges

Salaries and other payroll charges, including provisions for vacation pay, 13th salary and complementary payments agreed upon through collective bargaining agreements, added by the corresponding payroll charges, are recorded on an accrual basis.

(o) Provision for Contingencies

Provisions for contingencies are recorded at the estimated amounts to cover potential losses related to labor, tax, civil, commercial, environmental and other claims and lawsuits, at administrative and court levels, when such losses are considered probable by the Company's legal advisors and are estimateable by management.

Provisions for contingencies balances are being disclosed net of the related escrow deposits for 2006 and 2005.

(p) Environmental costs

Costs relating to ongoing environmental programs are expensed, as incurred. Ongoing programs are designed to minimize the environmental impact of operations and to manage the environmental risks inherent to the Company's activities. Provisions for contingent losses related to environmental claims are recorded when they are considered to be probable and reasonably estimated by Management.

(q) Pension obligation

The Company sponsors a private defined benefit pension plan, which is operated and administered by Fundação SABESP de Seguridade Social (SABESPREV). CVM resolution 371 of December 13, 2000 determines the recognition of actuarial liabilities exceeding the plan assets. As permitted, the Company has elected to recognize the transition obligation as of the date of adoption in earnings on a straight-line basis over five years beginning January 1, 2002.

(r) Interest on shareholders' equity

Brazilian corporations are permitted to deduct for tax purposes interest on shareholders' equity, which is a distribution similar to a dividend. For financial reporting purposes, interest on shareholders' equity is recorded as a deduction directly from unappropriated retained earnings. This interest has been recorded in accordance with Law 9249/95, for tax deductibility purposes, limited to the daily pro-rata variation of the Long-Term Interest Rate (TJLP). Withholding taxes with respect to the payment of interest on shareholders' equity is generally withheld and paid by the Company on behalf of shareholders (see note 16).

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(s) Use of estimates

The preparation of financial statements requires management to make estimates based on certain assumptions that affect the reported amounts of assets and liabilities and the reported amounts or revenues and expenses for the reporting periods. Actual results could differ from those estimates.

(t) Earnings per share

Earnings per share is calculated based on the number of shares outstanding at the balance sheet date.

4. CASH AND CASH EQUIVALENTS

	2006	2005
Cash and banks	80,118	124,455
Financial investments	248,088	155,718
	328,206	280,173

5. CUSTOMER ACCOUNTS RECEIVABLE

The following summarizes customer accounts receivable balances at December 31:

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	2006	2005
(a) Private-sector customers		
General customers and special customers (i) (ii)	667,143	687,155
Agreements (iii)	179,353	142,139
	846,496	829,294
Government Entities:		
Municipal	446,495	377,373
Federal	23,524	19,391
Agreements	85,909	59,408
	555,928	456,172
Wholesale customers - municipal authorities: (iv)		
Guarulhos	340,534	294,035
Mauá	115,189	94,887
Mogi das Cruzes	4,139	4,145
Santo André	289,592	256,063
São Caetano do Sul	2,932	2,708
Diadema	85,620	76,054
Total wholesale customers - municipal authorities	838,006	727,892
Unbilled amounts	290,578	239,832
Subtotal	2,531,008	2,253,190
Allowance for doubtful accounts	(1,123,157)	(920,736)
Total	1,407,851	1,332,454
Current portion	1,111,289	1,069,098
Non current portion (v)	296,562	263,356

(i) General customers - residential and small and medium-sized businesses.

(ii) Special customers - large consumers, commercial industries, plants, condominiums and special billing consumers (industrial waste, wells, etc.)

(iii) Agreements - renegotiation of past due debts into installments, added by monetary variation and interests, with maturity dates between 6 and 12 months, except for agreements with municipal City Halls, with maturity dates up to 2011.

(iv) Wholesale customers - municipal authorities - Accounts receivable from wholesale customers relate to the wholesale of treated water to certain municipalities, which are responsible for distribution, billing and collection with the final customers, some of these municipalities judicially contest the tariffs charged by Sabesp and do not pay the amounts in dispute. Based on the collection history, these amounts are classified as non current assets, as demonstrated below:

	2006	2005
Balance in the beginning of year	727,892	632,244
Billings for services provided	265,298	241,126
Collections -current year services	(133,926)	(113,496)
Collections - prior years services	(21,258)	(31,982)
Balance at end of year	838,006	727,892
Current portion	16,170	13,092
Non current portion	821,836	714,800

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(v) The non current portion comprises past due and renegotiated accounts receivable with customers and past due amounts from the wholesale supply to municipal authorities, and it is recorded net of the allowance for doubtful accounts.

(b) Customer accounts receivable aging summary

	2006	2005
Current	705,863	669,917
Past due:		
Up to 30 days	247,970	174,129
From 31 to 60 days	72,064	86,206
From 61 to 90 days	48,962	61,743
From 91 to 120 days	40,540	52,237
From 121 to 180 days	71,101	95,253
From 181 to 360 days	186,387	114,382
For more than 360 days	1,158,121	999,323
Total	2,531,008	2,253,190

(c) Allowance for doubtful accounts

(i) Changes in the allowance for doubtful accounts are as follows:

	2006	2005
Balance at beginning of year	920,736	759,640
Private-sector customers/government entities	87,160	23,457
Wholesale customers	115,261	137,639
Additions in the fiscal year	202,421	161,096
Balance at end of year	1,123,157	920,736
Current portion	501,500	401,104
Long-term portion	621,657	519,632

(ii) In the income

Bad debt included as part of selling expenses for the years ended December 31 was as follows:

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	2006	2005	2004
Provisions (over five thousand reais)	(241,050)	(207,233)	(99,297)
Recoveries (over five thousand reais)	38,629	46,137	9,088
Direct write-offs (less than five thousand reais and adjustment (e))	(289,191)	(177,138)	(205,261)
Recoveries (less than five thousand reais)	79,694	82,942	53,893
Total bad debt expenses (note 20)	(411,918)	(255,292)	(241,577)

A number of wholesale customers have been contesting certain tariffs since mid-1998. As a result, some municipalities are currently not paying the Company's invoices in full or on a timely basis. In addition, some governmental entities located in municipalities the Company serves are also not paying on a regular basis. While the Company continues to enter into negotiations with municipalities to reschedule the related accounts receivable and continues to file legal proceedings against municipalities to collect overdue amounts, in some cases, the Brazilian courts have required that the Company continue to provide water on a wholesale basis to municipalities, even if they fail to pay the Company's invoices.

The Company recorded direct charges for probable losses in accounts receivable incurred in 2006, in the amount of R\$ 411,918, being R\$ 115,739 (net of recoveries) written-off from accounts receivable (in 2005 - R\$ 94,196), directly to the income for the year, recorded in Selling Expenses. These losses amounted to R\$ 255,292 and R\$ 241,577 in 2005 and in 2004, respectively.

Management believes that the allowance for doubtful accounts is sufficient to absorb probable losses in customer accounts receivable.

(d) Unbilled amounts

Unbilled amounts represent water and sewage services provided but not yet billed, which are estimated from the last measurement date to month-end based on prior month's billings.

(e) Unidentified collections

In the process of analyzing and reconciling the accounting balances related to the account unidentified collections, which belongs to the accounts receivable group, the Company identified the need to adjust the balance of this account in the amount of R\$93,758. This amount results from differences accumulated in the course of the years. The adjustment was made in the statement of income for the year ended December 31, 2006 due to the impossibility to identify the period of the amounts that caused the accumulated differences.

6. TRANSACTIONS WITH RELATED PARTIES

The Company is party to a number of transactions with its majority shareholder, the State Government, and its related agencies.

(a) Receivable from Shareholder	2006	2005
Current:		
Water and sewage services (i)	308,030	237,701
GESP Agreement (iii) (iv)	59,834	54,806
Total current	367,864	292,507

Long-term:

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Water and sewage services - GESP Agreement	89,012	127,879
Reimbursement for pension benefits paid (ii)	774,455	672,715
Gross long-term receivable from shareholder	863,467	800,594
Total receivable from shareholder	1,231,331	1,093,101
Water and sewage services	456,876	420,386
Reimbursement for pension benefits	774,455	672,715
	1,231,331	1,093,101
Interest on Shareholders' Equity	396,361	260,240
Operating Revenues		
Gross revenue from sales and services		
Water sales	175,124	161,798
Sewage services	146,074	134,313
Collections	(199,375)	(233,039)
Financial revenues	50,882	32,293

The Company does not record an allowance for doubtful accounts for any amounts due from the State government or entities controlled by the State Government, since it does not expect losses on such receivables.

(i) Water and sewage services

The Company provides water and sewage services to the State Government and its related agencies under terms and conditions that management believes are equal to those with third parties, except for the settlement of amounts outstanding, as described further below in items (iii) and (iv).

(ii) Reimbursement for pension and benefits paid.

Reimbursement for pension and benefits paid represents supplementary pension and leave benefit paid by the Company to former employees of State Government-owned companies which merged to form SABESP. These amounts should be reimbursed to the Company by the State Government, as the primary obligor, in conformity with Law No. 200/74. At December 31, 2006 and 2005, 2,670 and 2,761 retirees, respectively, received supplementary pension payments, for which the Company paid R\$ 101,740 and R\$ 96,388 at December 31, 2006 and 2005, respectively. There were 163 active employees at December 31, 2006, who will be entitled to such benefits at the time of their retirement, as compared to 189 at December 31, 2005.

(iii) GESP Agreement

On December 11, 2001, the Company entered into an agreement with the State of São Paulo Government, through the State Department of Finance and the State Department of Water and Energy - DAEE, having the State Department of Water Resources, Sanitation and Works as intervening party, under which the State Government, by force of Law no 200/74, acknowledged to be responsible for the benefit arising out of supplementation of retirement and pension payments and agreed to pay amounts it owed to the

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Company in respect of water and sewage services. The value to date of the Agreement was R\$ 678,830, of which R\$ 320,623 refer to supplemental retirement and pension benefits in the period from March 1986 until November 2001, and R\$ 358,207 refer to water supply and sewage collection services invoiced and due from 1985 until December 1, 2001. The agreement foresees the equalizing of the balance of our accounts receivable with the use of dividends, when applicable.

Considering the strategic importance of Taiacupeba, Jundiá, Biritiba, Paraitinga and Ponte Nova reservoirs, for ensuring the volume of water of the Alto Tietê System to be maintained, it was agreed that DAEE would transfer these properties to the Company, with the fair value of these transferred assets used to reduce the amounts owed to the Company.

Under the December 2001 agreement, in July and August 2002, a State Government owned construction company (Companhia Paulista de Obras e Serviços CPOS), on behalf of the State, and an independent appraisal firm (ENGEVAL Engenharia de Avaliações), on the Company's behalf, presented their valuation reports relating to the reservoirs. Under the agreement, the arithmetic average of these appraisals is deemed the fair value of the reservoirs. The appraisals contained in these reports were in the amounts of R\$ 335.8 million and R\$ 341.2 million, respectively. Because the Company had already made investments in these reservoirs by then, the arithmetic average of the appraisals submitted to the Company's Board of Directors for approval in August 2002 of R\$ 300.9 million was net of a percentage corresponding to these investments. Our Board of Directors approved the valuation reports.

Under the December 2001 agreement, for amounts due in excess of the fair value of the reservoirs, the State Government is to make payments in 114 consecutive monthly installments, with the first payment to be made upon the latest of (1) 210 days after the date of the agreement, (2) agreement by the parties on the fair value of the reservoirs and (3) conclusion of the audit by a State-appointed auditor of amounts owed. The nominal amount owed by the State Government would not be indexed to inflation or earn interest if there was a delay in concluding the appraisal of fair value. The installments will be indexed on a monthly basis by the IGP-M, plus 6.0% per year, starting on the date the first installment becomes due. The original first payment was to be made in July 2002.

On October 29, 2003, the Public Attorney of the State (Ministério Público do Estado de São Paulo), on behalf of the people of the State, brought a civil public action in a Trial Court of the state of São Paulo (12a Vara da Fazenda Pública do Estado de São Paulo) alleging that a transfer to the Company of ownership of the Alto Tietê System reservoirs from DAEE would be illegal. An injunction against the transfer of ownership of such reservoirs was granted but was later reversed. However, in October 2004, the court ruled in favor of the Public Attorney of the State, which the Company believes relates only to the illegality of the transfer of the reservoirs. In response, the Company filed an appeal which is pending final decision and the State Government successfully filed an action suspending the lower Court's decision until final judgment is reached by the Court of Appeals of the state of São Paulo (Tribunal de Justiça do Estado de São Paulo). The Company is unable to predict whether it will succeed in appealing such decision. Management currently does not expect that an eventual unfavorable decision would have material adverse effect on the Company's business and financial condition.

The December 2001 agreement also provided that the legal advisors of the State Government would carry out specific analyses, which have commenced, to ensure agreement among the parties as to the methodology employed in

determining the amount of reimbursement for pension benefits owed to us by the State Government. Management does not expect these analyses to differ significantly from the amounts recorded in respect of these amounts. The commencement of payments with respect to pension amounts owed by the State Government has been postponed until such analyses are completed, the appraisal report is approved and the credit assignments relating to the transfer of the reservoirs described above are formalized. In addition, the transfer of these reservoirs is currently being disputed and we are not certain whether such transfer will be legally allowed, as discussed above.

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Based on Official Notice No. 53/2005 of the State Capital Defense Council (CODEC), dated March 21, 2005, negotiations are still ongoing between the Company and the State Government with a view to restatement of the debt for supplemental retirement and pension benefits, under the terms defined in the December 2001 agreement, including amounts due after November 2001. These negotiations are expected to be consolidated in a second amendment to the December 2001 agreement, including criteria for recovery of future amounts to be disbursed by the Company. The Company has retained Fundação Instituto de Pesquisas Contábeis, Atuariais e Financeiras, USP - FIPECAFI to validate the actual values to be reimbursed by the State Government, taking into account the legal advice provided by the General Office of the State Attorney provided by the Office of the State Attorney General.

It is not possible to determine the net effects on the balance sheet resulting from such negotiation. Management does not expect to incur significant net losses relating to any differences between the amounts recorded as due from the State Government and the amounts expected to be received by Sabesp.

The following summarizes activity with respect to amounts due from the State Government related to the reimbursement of pension and retirement benefits:

	December 31,	
	2006	2005
Receivable from shareholder reimbursement for pension benefits paid:		
Balance at beginning of the year	672,715	576,326
Payments made on behalf of State Government	101,740	96,389
Balance at end of the year	774,455	672,715

Management continues to believe that the amounts due from the State Government are collectible and does not expect to incur losses on these accounts receivable.

The balances for water and sewage services were included in the 1st amendment, as described below (iv).

(iv) First Amendment to GESP Agreement

On March 22, 2004, the Company and the State Government amended the terms of the original GESP Agreement, thereby (1) consolidating and acknowledging amounts due from the State Government for water and sewage services through February 2004, monetarily adjusted through February 2004; (2) formally providing for the offset of amounts due from the State Government against interest on shareholders' equity declared by the Company and any other debt owed to the State Government at December 31, 2003, which were monetarily adjusted through February 2004; and (3) defining the payment terms of the remaining obligations of the State Government for water and sewage services.

Under the terms of the Amendment, the State Government acknowledged amounts due to the Company for water and sewage services provided through February 2004, in the amount of R\$ 581,779, including monetary adjustments based on the Reference Rate (TR) at the end of each fiscal year through February 2004. The Company acknowledged amounts due to the State Government with respect to interest on

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shareholders' equity of R\$ 518,732, including (1) amounts declared and paid relating to years prior to 2003 (R\$ 126,967), (2) monetary adjustments on these amounts based on the annual change in the Consumer Prices Index (IPC/FIPE) through February 2004 (R\$ 31,098); and (3) amounts declared and paid relating to 2003 (R\$ 360,667).

The Company and the State Government have agreed to the reciprocal offset of R\$ 404,889 (monetarily adjusted through February 2004). The remaining obligation of R\$ 176,890 at February 29, 2004 will be payable in monthly installments from May 2005 through April 2009, which will be subject to monthly monetary adjustment at the Expanded Consumer Price Index (IPCA/IBGE), plus 0.5% .

In 2005 the offset of R\$ 105,520 with interest on shareholders' equity from 2003 occurred, as forecasted. In 2006, the Company received the amount of R\$ 47,228 corresponding to the installments from January through October. On March 2007, the company received the amount of R\$ 25,261 corresponding to the installments from November 2006 through March 2007.

The Amendment to the GESP Agreement does not provide for amounts owed by the State Government for supplementary retirement and pension plan benefits, paid by the Company on behalf of the State Government. Such amounts continue to be subject to the terms of the original GESP Agreement. Part of such amounts may be netted upon the transfer of the reservoirs that make up the Alto Tietê System. As discussed above, the Company and the State Government are negotiating the transfer and netting of the additional amounts owed.

Management believes that the amounts owed by the State Government shall be received and it is not estimated that losses will be incurred with such accounts receivable. Management continues its efforts to maintain in permanent basis the payments of the State with regards to the transactions between the parties.

(b) Cash and cash equivalents

The Company's balance of cash and short-term investments accounts with financial institutions controlled by the State Government was R\$ 287,999 and R\$ 242,021 at December 31, 2006 and 2005, respectively. The financial income from such investments was R\$ 50,882, R\$ 32,293 and R\$ 23,114 in fiscal years ended December 31, 2006, 2005 and 2004, respectively. The Company must, by force of State Decree, invest its excess resources together with financial institutions controlled by the State.

(c) Arrangements to use reservoirs

The Company uses the Guarapiranga and Billings reservoirs and a portion of some of the reservoirs of the Alto Tietê System, which are owned by the State Department of Water and Energy (DAEE). The Company does not pay any fees with respect to the use of these reservoirs, but is responsible for maintaining and funding the operating costs of these reservoirs. The State of São Paulo does not incur such costs on behalf of the Company. In the event these facilities had not been made available to the Company, it would have had to obtain water from more distant sources which would have been more costly.

As part of these arrangements, the Company funded approximately R\$97,115 of costs for the 1992 and 1997 projects. A portion of these project costs were funded by the State Government, through DAEE. The agreements included the construction of ducts, tunnels and other facilities to interconnect the Tietê River with the Biritiba and Jundiaí reservoirs and other bodies of water in exchange for the Company's use of the reservoirs during a 30-year period.

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The Company has the right to draw water from and release emissions into the reservoirs during a 30-year period which began in 1997. The Company capitalizes expenditures on the facilities constructed. The assets relating to the original reservoir project were placed in service in 1994 and 2002 and are being depreciated over the remaining term of the original 30 year period. The Company had recorded as part of property, plant and equipment R\$ 55,660 and R\$ 58,397 of amounts capitalized with respect to these agreements, net of accumulated depreciation, at December 31, 2006 and 2005, respectively.

(d) Contracts with reduced Fare for State and Municipal Public Entities that adhere to the Program of Rational Use of Water

The Company has entered into contracts with public entities related to the State Government and other municipalities involving approximately 6,800 properties that are benefited with a 25% tariff reduction for water and sewage services. The contract provides for the implantation of the program of rational use of water, which considers the reduction in water consumption.

(e) Guarantees

The State Government and the Brazilian Federal Government, in some cases, provide guarantees of, or security for, the Company's loans and financing. The Company does not pay any fees with respect to these guarantees.

7. INDEMNITIES RECEIVABLE

Indemnities Receivable is a non current asset representing amounts receivable from the municipalities of Diadema and Mauá as indemnification for the unilateral withdraw of the concessions of water and sewage services from the Company in 1995. On December 31, 2006 this asset amounted to R\$ 148,794.

Under these concession agreements, the Company invested in the construction of water and sewage systems in those municipalities in order to meet its concession services commitments. Due to the unilateral termination of the concessions of Diadema and Mauá, the municipalities have assumed the responsibility to provide water and sewage services in those areas. At that moment, the Company reclassified the property, plant and equipment balances related to the impounded assets used in those municipalities to non current assets (indemnities receivable) and it has recorded non indemnifiable costs in order to reflect the assets by the recoverable amounts contractually estimated as indemnification by the Company before the competent authorities. The net book value of the property, plant and equipment items related to the municipality of Diadema, written-off for accounting purposes in December 1996, was R\$ 75,231 and the indemnification balance and other credits receivable from the municipality was of R\$ 62,876 on December 31, 2006. The net book value of the property, plant and equipment items related to the municipality of Mauá, written-off in the fiscal year 1999, was R\$ 103,763, and the balance of indemnifications receivable from the municipality was R\$ 85,918 on December 31, 2006.

The Company's rights to the recovery of these amounts are being disputed by the municipalities and no amount has been received up to the date.

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Sabesp filed judicial demands to collect the amounts due by the municipalities. With regards to Diadema, the first court level judge decided against Sabesp, against which there was an appeal in November 2000. On December 1, 2005 a partial acceptance to Sabesp's appeal was granted to declare the validity of the agreement entered into with the municipality of Diadema. On November 11, 2006 the City Hall filed special and extraordinary appeals, and on November 21, 2006 the decision allowing the Company to present its responses to the referred appeals was published, which has been done on December 6, 2006.

With regards to Mauá, a first court level decision was given requiring that the Municipality pay an amount of R\$ 153.2 million as compensation for the loss of profits. This decision was appealed by Mauá on April 15, 2005 and it is still pending a decision by the Court of Justice. On July 4, 2006, the sentence was converted into a diligence comprised by an expert clarification about the amount attributed for indemnification purposes, which has not yet been provided by the expert.

Based on the legal counsel opinion, Management continues to affirm that the Company has legal right to receive the amounts corresponding to the indemnification and it continues to monitor the situation of the legal proceedings. However, the ultimate amounts to be received, if any, will most likely be subject to a final court decision. As such, actual amounts received could differ from those recorded.

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8. PROPERTY, PLANT AND EQUIPMENT

	December, 31	
	2006	2005
In use:		
Water systems:		
Land	941,757	938,589
Buildings	2,717,073	2,660,875
Connections	833,600	800,544
Water meters	277,623	272,240
Networks	3,328,333	3,235,646
Equipment	265,552	246,893
Other	599,216	498,950
	8,963,154	8,653,737
Accumulated depreciation	(3,365,745)	(3,074,797)
Total water systems	5,597,409	5,578,940
Sewage system:		
Land	346,471	352,080
Buildings	1,516,769	1,456,577
Connections	881,024	846,334
Networks	4,933,032	4,660,594
Equipment	436,444	500,449
Other	126,899	15,493
	8,240,639	7,831,527
Accumulated depreciation	(2,476,692)	(2,222,011)
Total sewage systems	5,763,947	5,609,516
General use:		
Land	107,707	102,952
Buildings	133,705	120,853
Transportation equipment	136,129	133,433
Furniture, fixtures and equipment	310,122	280,097

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Accumulated depreciation	687,663 (407,012)	637,335 (368,534)
Total general use	280,651	268,801
Non Operational assets, net of accumulated depreciation	26,478	31,832

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Subtotal	11,668,485	11,489,089
Construction in progress:		
Water systems	708,097	683,094
Sewage systems	1,454,994	1,421,491
Other	5,922	19,907
	2,169,013	2,124,492
	13,837,498	13,613,581

The fixed assets represent the assets involved in the service providing of supply of water and collection of sewage in 352 municipalities. In the other municipalities, which were negotiated by financial economic appraisal, described in the item above, SABESP holds the possession of the assets.

In 2006, 120 (one hundred twenty) concession contracts expired, being that all of them are under negotiation. The net book value of the fixed assets in the Municipalities where the concessions are under negotiation (2006) or that will expire in 2007 amounts to R\$ 1.94 billion.

In 2006, the depreciation costs of these municipalities were of R\$ 122,785.

The concession contracts provide that the assets shall turn to the conceding power at the end of the term, either by means of indemnification by the residual amount or market value in accordance with the established in each agreement.

(a) Depreciations

Depreciation is calculated at the following annual rates: - buildings - 4%, networks - 2%, furniture, fixtures and equipment - 10%, water meters - 10%, vehicles - 20%, IT hardwares - 20%, residential connections- 5% and office furniture - 10%.

(b) Disposals of property, plant and equipment

The Company wrote-off property, plant and equipment in the amount of R\$ 54,350, R\$ 19,051 and R\$ 34,616 in 2006, 2005 and 2004, respectively. Of these losses, R\$ 21,348, R\$ 9,879 and 26,034 in 2006, 2005 and 2004, respectively, were related to the obsolescence, theft or disposal of assets in use. The remaining balances of losses, of R\$ 26,459, R\$ 9,172 and R\$ 8,582 were related to the write-off of construction in progress projects which were determined to be no longer economically feasible.

Studies supporting the write-offs for obsolescence and construction-in-progress were concluded by the Company in the accounting period of the write-off, based on undiscounted cash flow projections, and have been approved by Management. The carrying value of property, plant and equipment is monitored on an on-going basis and is adjusted, when appropriate, to assure future projected operating revenue is sufficient to recover the carrying value of the assets. When applicable, depreciation rates are adjusted to take into account changes in estimated remaining economic lives as assets are replaced.

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(c) Capitalization of interests and financial charges

The Company capitalized interests and monetary variation, including foreign currency exchange variation, to property, plant and equipment in the amount of R\$ 5,784 for the year ended on December 31, 2006 (2005 - R\$ 4,335), during the period in which the related assets were under construction.

(d) Construction in Progress

Construction in progress primarily related to new projects and operating improvements, are as follows:

	2006	2005
Water systems:		
Networks and connections	227,360	238,122
Transmission	29,626	36,712
Water treatment	80,130	97,502
Sub-transmission	188,342	155,493
Production and storage	126,519	116,306
Other	56,120	38,959
Total water systems	708,097	683,094
Sewage systems:		
Collection	1,133,958	1,139,045
Treatment	187,047	182,967
Others	133,989	99,479
Total sewage systems	1,454,994	1,421,491
Others	5,922	19,907
Total	2,169,013	2,124,492

Estimated disbursements relating to construction works already contracted are estimated to be approximately R\$ 1,009 million for fiscal years from 2007 to 2012 (unaudited).

(e) Expropriations

Development of major water and sewage systems frequently requires the expropriation or establishment of rights of way through third-party properties. The owners of these properties are generally compensated either through

negotiated settlements or judicial arbitration.

Disbursements to be effected as from fiscal year 2007 are estimated to be approximately R\$ 467 million (unaudited), which will be paid out of Company funds. The related assets acquired as a result of these negotiations are recorded as property, plant and equipment when the expropriation is complete. In 2006, the amount referring to expropriations was R\$ 8,385 (2005 - R\$ 11,472).

(f) Assets in guarantee

At December 31, 2006 and 2005, the Company had assets in the amount of R\$ 249,034 provided as guarantee under the Special Tax Debt Refinancing Program - PAES (Note 12).

Additionally, three of the Company's real estate properties, in the amount of R\$ 60,539, have been pledged as guarantee for financing together with the International Bank for Reconstruction and Development - Bird (note 10).

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(g) Non-operating assets

The Company had R\$ 26,478 at December 31, 2006 (2005 - R\$ 31,832) referring to other non-operating assets given as free leases, comprised primarily of lands surrounding reservoirs.

(h) Revaluation

Property, plant and equipment items were revaluated in 1990 and 1991 and have been depreciated at annual rates which take into consideration the estimated remaining economic useful lives of the assets as determined in the respective valuation reports that, as a rule, fall within the ranges of the above presented rates.

(i) Totally depreciated assets

On December 31, 2006 the gross accounting value of the totally depreciated assets which are still in use is R\$ 426,659 (2005 - R\$ 336,086).

9. INTANGIBLE ASSETS**(a) Concessions**

Beginning in 1999, negotiations and acquisition of new concessions considers the financial economic value of the business, defined in an appraisal report, issued by independent experts.

The terms of these concessions are generally for a period of 30 years and generally include the corresponding right to operate the related concession assets for which the Company does not have title. The purchase price for these concessions is generally the fair value of the concession, based on appraisal reports which take into consideration the projected cash flows and the remaining concession period at the date of acquisition. The cost of the concession assets acquired is amortized over the concession period using the straight-line method.

The net disclosed amount refers to the assumption of the following municipalities:

Municipalities	Year ended December 31,	
	2006	2005
Agudos	7,538	7,331
Bom Sucesso do Itararé	338	131
Campo Limpo Paulista	11,811	11,509
Conchas	2,250	2,171
Duartina	1,462	1,459
Estância de Serra Negra	13,255	11,423
Itapira	14,729	14,762

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Itararé	5,554	5,508
Marabá Paulista	444	358
Miguelópolis	4,083	3,978
Osasco	269,068	260,013
Paraguaçu Paulista	14,166	13,966
Paulistânia	150	149

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Sandovalina	215	211
Santa Maria da Serra	1,090	885
São Bernardo do Campo	237,459	237,459
Várzea Paulista	11,999	11,668
Total	595,611	582,981
Less accumulated amortization	(100,493)	(80,463)
Concession assets, net	495,118	502,518

Amortization expense related to intangible concession rights was R\$ 20,030, R\$ 19,617 and R\$ 18,259 for the years ended December 31, 2006, 2005 and 2004, respectively. Amortization expense for the next five years is estimated to be approximately R\$ 20,000 per year.

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10 - LOANS AND FINANCING

	2006			2005			Guarantees	Final Maturity Date	Annual interest rate	Adjusted to
	Current	Non Current	Total	Current	Non Current	Total				
In local currency: Banco do Brasil							State of S. Paulo Government and Own Funds			
Debentures 4th Issue	215,723	1,854,042	2,069,765	194,238	2,028,429	2,222,667		2014	8.50%	
Debentures 5th Issue	-	-	-	99,998	-	99,998		2006	CDI+1.2%	
Debentures 6th Issue	46,038	-	46,038	148,917	148,917	297,834		2007	10.65%	
Debentures 7th Issue	231,813	397,165	628,978	-	614,383	614,383		2010	CDI+1.75% / 11%	
Debentures 8th Issue	-	304,350	304,350	-	300,516	300,516		2010	CDI+1.5% / 10.8%	
Caixa Econômica Federal FIDC - Sabesp I Brazilian Economic and Social Development Bank - BNDES	-	709,815	709,815	-	696,594	696,594		2011	CDI+1.5% /	
	49,648	477,628	527,276	42,938	459,919	502,857	Own Funds	2007/2022	10.75%	
	55,555	180,556	236,111	-	-	-	Own Funds	2011	5% to 9.5% CDI + 0.70%	
Other	31,515	154,043	185,558	28,699	182,358	211,057	Own Funds	2013	3% + TJLP LIMITE 6% 12% / CDI /TJLP + 6%	

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Accrued Interest and financial charges	99,252	20,891	120,143	115,554	-	115,554				
	732,335	4,121,626	4,853,961	632,849	4,455,424	5,088,273				
In foreign currency: Eurobonus: US\$ 238,052 thousand (2005 -US\$ 225,000 thousand)	-	508,955	508,955	-	526,658	526,658		2008/2016	12% / 7.5%	Cu
Interamerican Development Bank (IDB): US\$ 435,867 thousand (2005-US\$ 435,451 thousand)	99,930	831,952	931,882	101,157	918,103	1,019,260	Federal Government	2007/2025	3.00% to 7.70%	bs
International Bank for Reconstruction and Development - BIRD (World Bank): US\$ 2,223 thousand (2005-US\$ 6,439 thousand)	4,752	-	4,752	10,049	5,023	15,072	Federal Government	2007	5.15%	-
JBIC - Yens 652,814 Société Générale: (2005- 1,020 thousand)	-	11,721	11,721	-	-	-	Federal Government	2029	1.8% / 2.5%	-
Accrued Interest and financial charges	15,458	-	15,458	12,134	-	12,134	Federal Government	2006	4.04%	-
	120,140	1,352,628	1,472,768	126,164	1,449,784	1,575,948				
	852,475	5,474,254	6,326,729	759,013	5,905,208	6,664,221				

Total loans and
financing

Exchange rate at December 31, 2006: US\$ 2.1380; Yens 0.017954 - (2005 - US\$ 2.3407; Euro 2.76905)
On December 31, 2006 the Company did not record any balances of short-term loans and financing.

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(a) Banco do Brasil

In March 1994, existing loan agreements with Caixa Econômica Federal were refinanced and the loan rights were transferred by that financial institution to the Federal Government, with Banco do Brasil acting as an agent. Under the terms of the agreement signed with the Federal Government, charges and payments are made on the Price amortization system, indexed monthly to the Standard Reference Unit (UPR), which is equal to the Government's benchmark Interest Rate (TR), plus interest 8.5% per year. Interest and principal are payable monthly, with final maturity in 2014. This financing is guaranteed by the State of São Paulo Government's revenue and by the Company's own revenues.

(b) Debentures

(i) 4th Issue

On April 1, 2001 the Company made a public placement of 30,000 non-convertible, registered, book-entry type, single series, non-renegotiable debentures, at the unit value of R\$ 10, in an aggregate amount of R\$ 300,000. The placement of these debentures in the local market occurred through an auction held on June 8, 2001 and the payment of the last installment occurred on December 15, 2006.

(ii) 5th Issue

On April 1, 2002 the Company made a public placement for the 5th issue of simple, book-entry, registered, unsecured, non-convertible debentures, with face value of R\$ 10. The amount of the 2nd issue is monthly changed, due to its characteristics, in accordance with the indenture.

40,000 debentures were issued, distributed in two series, as follows:

	1 st Series	2 nd Series
Placement date	05/16/2002	05/16/2002
Number	31,372	8,628
Face value of Issue	R\$ 313,720	R\$ 86,280
Original yield	CDI + 1.85% per year	IGP-M + 13.25% per year
Interest payments	Quarterly, except for last installment on 03/01/2007	Annual, except for last installment in 03/01/2007
	3 installments on 04/01/2005,	3 installments on 04/01/2005,
Amortization	04/01/2006 and 03/01/2007	04/01/2006 and 03/01/2007

The interest rates for the two series were renegotiated for the last time in April 2005, whereby the rate for the 1st Series was changed from CDI + 2.0% per year to CDI + 1.1% per year, and the rate for the 2nd Series was changed from IGPM + 12.7% per year to IGPM + 10.65% per year, in effect until the agreement conclusion.

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Interest expense was R\$ 10,991, R\$ 45,015 and R\$ 54,376 in 2006, 2005 and 2004, respectively relating to the 1st Series, and R\$ 6,089, R\$ 11,584 and R\$ 16,641, respectively, relating to the 2nd Series. The remaining accrued interest balance of R\$ 3,571 (2005 - R\$ 7,032 and 2004 - R\$ 12,328) relating to the 2nd Series is recorded under Loans and financing, in current liabilities.

On April 19, 2006, the Company made the anticipated settlement of the 5th issue of debentures, 1st series which maturity was scheduled for March 2007, through the use of part of the resources obtained from the funding of the Investment Fund in Credit Rights Sabesp I - FIDC, in the amount of R\$ 106,373.

(iii) 6th Issue

On September 17, 2004, the Company registered with the CVM a securities program in the total amount of R\$ 1,500,000. As part of such program, on September 1, 2004 the Company issued 600,000 debentures, distributed in three series, without renegotiation with face value of R\$ 1, totaling R\$ 600,000. The date of the financial settlement of the transaction was September 21, 2004 for the 1st series, and September 22, 2004, for the 2nd and 3rd series.

The debentures were placed on the market as follows:

	Amount	Adjustment	Interest	Interest payment	Amortization	Maturity date
1 st Series	231,813	-	CDI+1.75% p.a.	Semiannual	Single payment	Sep/2007
2 nd Series	188,267	IGP-M	11%	Annual	Single payment	Sep/2009
3 rd Series	179,920	IGP-M	11%	Annual	Single payment	Sep/2010

Interest expense was R\$ 38,054, R\$ 46,481 and R\$ 13,484 in 2006, 2005 and 2004, respectively, relating to the 1st series; R\$ 21,932, R\$ 21,420 and R\$ 6,757, respectively, relating to the 2nd series, and R\$ 20,960 and R\$ 20,470, respectively, relating to the 3rd series. Remaining accrued interest balances to be paid in the amount of R\$ 10,974 (2005 - R\$ 14,837 and 2004 - R\$ 13,484) for the 1st series; R\$ 6,841 (2005 - R\$ 6,757 and 2004 - R\$ 6,757) for the 2nd series, and R\$ 6,538 (2005 - R\$ 6,458 and 2004 - R\$ 6,457) for the 3rd series. Such amounts are recorded under Loans and financing in current liabilities.

(iv) 7th Issue of Debentures

Within the program registered together with the CVM on September 17, 2004, the Company issued, in March 1, 2005, 300,000 debentures distributed into two series, without renegotiation, at the par value of R\$ 1, totaling R\$ 300,000. The date of the financial settlement was March 14, 2005.

The debentures were placed in the market as follows:

	Amount	Adjustment	Interests	Interest Payment	Amortization	Maturity Date
1 st series	200,000	-	CDI + 1.5%p.a.	Semiannual	Single payment	Mar/2009
2 nd series	100,000	IGP-M	10.80%	Annual	Single payment	Mar/2010

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Interest expense was R\$ 32,305 and R\$ 33,378 in 2006 and 2005, respectively, relating to the 1st series; and R\$ 11,162 and R\$ 9,013, respectively, relating to the 2nd series. Remaining accrued interest balances to be paid, in the amount of R\$ 9,304 (2005 - R\$ 12,631) for the 1st series and R\$ 9,218 (2005 - R\$ 9,013) for the 2nd series, are recorded under Loans and financing in current liabilities.

(v) 8th Issue of Debentures

In completion to the program registered at the CVM on September 17, 2004 the Company issued, on June 1st, 2005, 700,000 debentures, using the option to increase the quantity of debentures allowed up to 20%, according to the paragraph 2 of article 14 of the CVM inscription nr. 400/03, distributed in two series, without renegotiation, at par value of R\$ 1, amounting to R\$ 700,000. The settlement date of the financial operation was June 24, 2005. The amount received has been destined to the settlement of the Eurobonds contract (note 10 (f(i))).

The debentures were placed in the market as follows:

	Amount	Adjustment	Interests	Interest Payment	Amortization	Maturity Date
1 st series	350,000	-	CDI+1.5% p.a.	Semiannual	Single payment	Jun/2009
2 nd series	350,000	IGP-M	10.75% p.a.	Annual	Single payment	Jun/2011

Interest expense was R\$ 56,385 and R\$ 41,028 in 2006 and 2005, respectively, relating to the 1st series, and R\$ 37,953 and R\$ 21,420, respectively, relating to the 2nd series. Remaining accrued interest balances to be paid, in the amount of R\$ 3,668 (2005 - R\$ 5,341) for the 1st series, and R\$ 21,773 (2005 - R\$ 21,420) for the 2nd Series, are recorded under Loans and financing in current liabilities.

Financial covenants of the 6th, 7th and 8th issue of debentures

- Adjusted current ratio (current assets divided by current liabilities, excluding from the current liabilities the short-term portion of the long-term debts undertaken by the Company) over 1.0.
- EBITDA/Financial Expenses equal to or less than 1.5.
- Non-compliance with these obligations will not be evidenced unless if recorded in quarterly financial statements, for at least two consecutive quarters, or for two non-consecutive quarters within a period of twelve months.

(c) Caixa Econômica Federal

Pro-Sanitation Program

(i) Water and sewage agreements

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From 1996 through 2004, the Company entered into several loan agreements under Pro-Sanitation Program, with a view to expanding and improving the water supply and sewage systems of several municipalities of the State of São Paulo and of the City of São Paulo. The loans are collateralized by collections of the daily billings from water supply and sewage services up to the total amount of the debt.

Contractually established repayment terms range from 120 to 180 months, from the date the related projects become operational.

The balance at December 31, 2006 is R\$ 506,221 (2005 - R\$ 482,984), being the amount to use from these contracts of R\$ 463,851.

Contract charges are as follows:

Contract executed in:			
	1996	1997	1998 - 2004
Interest rates	9.5% p.a.	6.5% to 8.0% p.a.	6.5% to 8.0% p.a.
In the grace period:			
Risk fee	1.0% on disbursed amount	1.0% on disbursed amount	0.6% p.a. or 2% p.a. on outstanding balance
Management fee	0.12% p.m. on contract value	2.0% p.a. on disbursed value	1.0% p.a. on disbursed value or 2% p.a. on outstanding balance for agreements executed in 2003-2004.
In the repayment stage:			
Management fee	Difference between calculation of installment	1.0% p.a. on	1.0% p.a. on

at the rate of	outstanding	outstanding
10.5%	balance	balance
p.a.		
less rate of		
9.5%		
p.a.		

(ii) Pro-sanitation Program - Pró-Sanear

In 1997 and 1998 contracts were signed under the Pro-Sanitation - Pró-Sanear program for the improvement of water and sewage services in several municipalities of the Metropolitan Region of São Paulo, with the participation of the communities receiving the services. The loans are collateralized by collections of the billings from water supply and sewage services up to the total amount of the debt. Contractually established repayment terms are 180 months from the date the related projects become operational. Outstanding loan balances at December 31, 2006 and 2005 were R\$ 21,055 (2005 - R\$ 19,873), being the amount available for use from these loans for projects already in progress of R\$ 10,885.

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Applicable financial charges:

Interest rate - 5.0% p.a.

Management fee (Grace period) - 2.0% p.a. on outstanding balance Management fee (amortization stage) - 1.0% p.a. on outstanding balance Risk fee (grace period) - 1.0% on disbursement

Financial covenants:

- Under the Performance Improvement Agreement, goals are set for financial indexes (operating margin, personnel expense margin and revenue evasion index) and operating indexes which, based on the previous 2 years, are semiannually projected for the next 2 years.

(d) BNDES

Agreement 01.2.619.3.1 - Executed in August 2002, in the total amount of R\$ 60,000, with the purpose of financing part of the Company's counterparty in the performance of the Tietê River Depolluting Project - Stage II, object also of loan agreement no. 1212/OC - BR, with the Interamerican Development Bank - IDB. The related project is in the execution stage and the outstanding balance at December 31, 2006 was R\$ 46,389 (2005 - R\$ 52,735).

Onlending agreement 10/669.748 -6, in the total amount of R\$ 180,000, distributed among the financial agents in the following proportions:

Agent	Amount
-------	--------

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Unibanco - União de Bancos Brasileiros S.A.	60,000
Banco BBA Creditanstalt S.A.	51,000
Banco Alfa de Investimento S.A.	39,000
Banco Itaú S.A.	30,000
Total	180,000

The related project is in the execution stage, the total amount disbursed at December 31, 2006 the outstanding balance was R\$ 139,169 (R\$ 158,322 in 2005). The onlending agreement funds are passed on from BNDES to the financial agents, and by the agents to the Company. The onlending agreement has the same purpose as the agreement entered into between BNDES and the Company, and the charges and amortization terms are equal for both, being::

Interest - Long-Term Interest Rate TJLP limited to 6% p.a., plus a spread of 3% per annum, payable quarterly during the grace period, and monthly in the repayment period.

The portion of the TJLP that exceeds 6% p.a. shall be incorporated into the outstanding balance.

Monthly principal repayments began in September 2005, with final maturity in February 2013.

The agreements are collateralized by part of the revenue from water and sewage services.

Financial covenants:

- Adjusted current ratio: over 1.0;
- EBITDA / ROL: equal or higher than 38%;
- Total connections (water and sewage) / own employees: equal to or higher than 520;
- EBITDA / Debt Service: equal to or higher than 1.5;
- Shareholders Equity / Total Liabilities: equal to or higher than 0.8.

(e) FIDC

On March 23, 2006 a single series of senior quotas and 26 (twenty six) subordinated quotas were issued, kept in deposit account in name of their respective holders, with unit value at the date of issuance corresponding to R\$500,000 (five hundred thousand reais). The senior quotas are being amortized in 54 (fifty four) monthly installments, beginning on October 2006 and with final maturity in 2011. On December 31, 2006 the balance related to the subordinated quotas was R\$ 14,316, recorded as Other Accounts Receivable in non current assets; the balance related to the senior quotas was R\$ 236,111 recorded as Loans and Financing. The subordinated quotas were underwritten and paid up exclusively by Sabesp. The fund has a profitability parameter corresponding to 100% (one hundred per cent) over the DI rate, added by a pre-fixed coupon of 0.70% (seventy centesimal points per cent) interest per year, based on 252 working days, observed the terms of its regulation.

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The Fund is managed by Caixa Econômica Federal and has as custody and underwriting agent Banco do Brasil S.A.

The resources obtained, in the amount of R\$ 250 million, were used by the Company for the settlement of debts during the year 2006.

(f) Eurobonds

(i) A foreign credit transaction was entered into in July, 1997, having UBS - Securities LLC as lead arranger and Deutsche Morgan Grenfell and BB Securities as co-lead arrangers, in the amount of US\$ 275,000 thousand, with interest rate of 10% p.a.. In July 28, 2005 the Company settled the total contract with the resources obtained through the 8th issue of debentures.

(ii) In June 2003, the Company issued US\$ 225 million 12% Notes due 2008. Interest is payable semiannually with final maturity in June 2008. The Bank of New York acted as lead arranger and The Bank of Tokyo Mitsubishi Ltd. as principal paying agent. These funds were used for final settlement of the Eurobonds issue of US\$ 200,000 thousand matured in July 2003.

On November 6, 2006 the Company partially settled this loan, in the amount of R\$ 272,811, with the resources obtained through the issue of Eurobonds in the amount of US\$140,000 thousand.

(iii) On November 3, 2006 an issue of Eurobonds took place (Eurobonds 2016) in the foreign market in the amount of US\$140,000 thousand, having as leader Deutsche Bank Trust Company Americas and as principal paying agent Deutsche Bank Luxembourg S.A., with interest rate of 7.5% p.a. paid semi-annually and with final maturity in November 2016. As mentioned in (ii) above, the resources were used for the advanced and partial settlement of the issue of Eurobonds of US\$225,000 thousand with final maturity in June 2008, and the redeemed amount was US\$126,948 thousand.

As a result of the advanced settlement of Eurobonds 2008, an amendment to the contract has been executed cancelling the obligation of financial covenants.

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Financial Covenants - for Eurobonus 2016.

Limiting the incurrence of new debt in such a way that:

- the total adjusted indebtedness in relation to Ebitda shall not be higher than 3.65
- the Company's debt service coverage ratio determined in the date of incurrence shall not be less than 2.35.

(g) Inter-American Development Bank (IDB)

Agreement 229 - In June 1987, the Company signed a loan agreement with the IDB for US\$ 163 million destined to the execution of a sewage program in the São Paulo Metropolitan Region. Semiannual principal repayments began in January 1994, with final maturity in July 2007. The loan bears interest of 7.7% per annum. A guarantee agreement between the Federative Republic of Brazil and the IDB was executed in June 1987, to warrant the provision of funds to meet the obligations set forth in the financing agreement. The outstanding balance of such agreement on December 31, 2006 was US\$ 13,047 thousand, equivalent to R\$ 27,894 (2005 - R\$ 61,051)

Agreement 713 - In December 1992, the Company signed a loan agreement with the IDB for US\$ 400 million destined to the execution of the Tietê River Clean-up Project - Stage I. Semiannual principal repayments began in June 1999, with final maturity in December 2017. The loan bears interest at variable rate based on the cost of funding to the IDB. A guarantee agreement between the Federative Republic of Brazil and the IDB was executed in December 1992, to warrant the provision of funds to meet the obligations set forth in the financing agreement. The outstanding balance of such agreement on December 31, 2006 was US\$ 237,593 thousand, equivalent to R\$ 507,974 (2005 - R\$ 593,868).

Agreement 896 - In December 1992, the Company signed an additional loan agreement with the IDB for US\$ 50 million for the Tietê River Clean-up Project - Stage I. This loan bears interest at 3.0% per annum. Semiannual principal repayments began in June 1999, with final maturity in December 2016. A guarantee agreement between the Federative Republic of Brazil and the IDB was executed in December 1992, to warrant the provision of funds to meet the obligations set forth in the financing agreement. The outstanding balance of such agreement at December 31, 2006 was US\$ 27,778 thousand, equivalent to R\$ 59,389 (2005 - R\$ 71,521).

Agreement 1.212 - In July 2000, the Company signed a loan agreement with the IDB for US\$ 200 million to finance the Tietê River Clean-up Project - Stage II. The related project is in the execution stage, the total amount disbursed in 2006 having been US\$ 38,803 thousand and the amount available for use from these loans is US\$ 36,098 thousand. The loan will be repaid in semiannual installments and the last one is in July, 2025. The loan bears interest semiannually, on the daily outstanding balance, at the annual rate determined in accordance with the costs of loans borrowed by the bank in the previous semester, plus a spread, being variable for each semester. The outstanding balance of such agreement at December 31, 2006 was US\$ 157,449 thousand, equivalent to R\$ 336,625 (2005 - R\$ 292,820).

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Financial covenants

- Agreement 229 - Long term debt must not exceed 1.5 times the shareholders' equity.
- Agreements 713, 896 and 1.212 - Tariffs must: a) produce enough revenue to cover the system operating expenses, including those related to management, operation, maintenance and depreciation; b) ensure profitability on property, plant and equipment of not less than 7%. During the performance of the project the outstanding balances of short-term loans must not exceed 8.5% of the Company's shareholders' equity.

(h) International Bank for Reconstruction and Development - BIRD

Agreement 3.504 - Aiming at transferring the funds of the agreement executed between the State of São Paulo and the BIRD in December 1992 and destined to the execution of the environmental clean-up of the Guarapiranga Basin, an onlending agreement between the State of São Paulo and the Company was executed in March 1993. In December 1992, a guarantee agreement was executed between the Federal Republic of Brazil and the BIRD, to warrant the provision of funds to meet the obligations set forth in the financing agreement. Semiannual principal repayments began in October 1997, with final maturity in April 2007. The loan bears interest at 0.5% p.a. above the BIRD's funding cost. The outstanding balance of such agreement at December 31, 2006 was US\$ 2,223 thousand, equivalent to R\$ 4,752 (2005 - R\$ 15,072).

(i) Japan Bank For International Cooperation (JBIC)

On August 06, 2004, the Company executed a financing agreement with the JBIC - Japan Bank for International Cooperation, guaranteed by the Federal Government, in the amount of 21,320 million Japanese Yens, equivalent to approximately R\$ 382,779, which is intended for the Environment Recovery Program for the Metropolitan Region of Santos Coastal Area. The total term of the financing agreement is 25 years, comprising 18 years for amortization in semiannual installments and 7 years for grace period. Interests will be paid semiannually beginning on January, 2006 at the rate of 2.5% p.a. for the sewage network and 1.8% p.a. for sewage treatment facilities. The outstanding balance of this contract in December 31, 2006 was R\$ 11,721.

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(j) Financial Commitments - Covenants

At December 31, 2006, the Company was in compliance with all debt covenants and, consequently, the balances of the loans and financings are duly classified between short and long term, in accordance to the contracts.

(k) Maturity dates of loans and financing

	2007	2008	2009	2010	2011	2012	2013 onward	Total
In local currency	732,335	388,976	1,165,681	737,389	781,555	427,543	620,482	4,853,961
In foreign currency	120,140	281,670	72,035	72,035	72,652	72,651	781,585	1,472,768
Total	852,475	670,646	1,237,716	809,424	854,207	500,194	1,402,067	6,326,729

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11. TAXES AND CONTRIBUTIONS

Income tax and social contribution (a federally mandated tax based on income) are accrued on taxable results at the applicable tax rates, generally 25% for income tax and 9% for social contribution tax (34% composite rate).

(a) Reconciliation of the effective tax rate

The amount recorded as income tax and social contribution expenses in the financial statements is reconciled from the nominal rates provided by law, as shown below:

	2006	2005	2004
Income before taxes on income	1,189,805	1,217,148	789,987
Statutory rate	34%	34%	34%
Tax expense at statutory rate	(404,534)	(413,830)	(268,596)
Permanent differences			
Realization of revaluation reserve	(34,772)	(30,413)	(35,530)
Interest on shareholders' equity	92,086	118,393	51,998
Other differences	(28,558)	9,471	10,291
Income and social contribution taxes	(375,778)	(316,379)	(241,837)
Current Income and social contribution taxes	(383,123)	(343,426)	(250,609)
Deferred Income and social contribution taxes	7,345	27,047	8,772
Effective rate	32%	26%	31%

(b) Composition of deferred taxes and social contributions

In current assets:	2006	2005
Provision for contingencies	7,078	10,730
Tax loss carryforwards	-	12,785
	7,078	23,515
In long-term assets:		
Provision for contingencies	226,265	197,486

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Provision for pension obligations	106,097	90,889
Other	10,292	10,445
	342,654	298,820
Total deferred tax assets	349,732	322,335
In current liabilities:		
Revenue from public entities	76,359	70,893
In non current liabilities		
Profit for governmental agencies	81,978	80,031

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COMPANHIA DE SANEAMENTO BÁSICO DO ESTADO DE SÃO PAULO - SABESP**NOTES TO THE FINANCIAL STATEMENTS**

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Revenue for governmental agencies	64,923	53,412
	146,901	133,443
Total deferred tax liabilities	223,260	204,336

(i) In current assets

Mainly calculated on temporary differences in the amount of R\$ 20,819 (2005 - R\$ 31,557). The tax loss carryforwards basis of social contribution accumulated in December 31, 2005 was R\$ 142,061 which was totally realized in 2006.

(ii) In long-term assets

Mainly calculated on temporary differences in the amount of R\$ 1,000,985 (2005 - R\$ 873,152) related to income tax and R\$ 1,026,756 (2005 - R\$ 894,795) related to social contribution.

As per a technical feasibility study, the temporary differences mentioned in items (i) and (ii) are likely to be realized in 2007.

(iii) In current liabilities

Substantially calculated on amounts invoiced to government agencies, with taxes being deducted upon receipt of the invoices.

(iv) In non current liabilities

-Income tax and social contribution

Substantially calculated based on temporary differences in the amount of R\$ 254,376 (2005 - R\$ 248,651) relating to income tax and R\$ 204,269 (2005 - R\$ 198,545) relating to social contribution.

- Pasep e Cofins

Substantially calculated on amounts invoiced to government agencies, which are accrued for when services are rendered and which are paid when the related amounts are effectively received by the Company.

(c) Tax effects on the revaluation of assets

As permitted by CVM Instruction 197/93, the Company did not record a provision for the tax effects (deferred taxes) on the surplus of the revaluation of property, plant and equipment carried out in 1990 and 1991. Had the income tax and social contribution on the revaluation reserve been accounted for, the unrealized amount at December 31, 2006 and 2005 would have been R\$ 430,375 and R\$ 461,068, respectively. In the years ended on December 31, 2006 and 2005, the realized revaluation reserve amounts were R\$ 102,272 and R\$ 89,449.

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12. TAXES PAYABLE

	Current		Non Current	
	2006	2005	2006	2005
Income tax	-	2,040	-	-
Social contribution	-	2,536	-	-
COFINS and PASEP	38,142	39,470	-	-
Paes	41,897	39,401	230,440	256,114
Inss	18,230	17,320	-	-
Other	7,283	5,364	-	-
Total	105,552	106,131	230,440	256,114

The Company applied for enrollment in the Special Tax Debt Refinancing Program (PAES) on July 15, 2003 in accordance with Law No. 10,684 of May 30, 2003, in which the Company included certain tax liabilities related to COFINS and PASEP, debts involved in a lawsuit brought against the enforcement of Law No. 9718/98, and consolidated the previously outstanding balance of tax liabilities included under the Tax Recovery Program (REFIS). The total amount of tax liabilities included in the PAES was R\$ 316,953, as follows:

Tax	Principal	Fine	Interest	Total
Cofins	132,499	13,250	50,994	196,743
Pasep	5,001	509	2,061	7,571
Refis	112,639	-	-	112,639
Total	250,139	13,759	53,055	316,953

The PAES obligation is being paid in 120 months. The amounts paid in 2006 and 2005 were of R\$ 40,824 and R\$ 37,986, respectively, and financial expenses were recorded in the amount of R\$ 17,646 and R\$ 24,852, respectively. The outstanding balance in December 31, 2006 was R\$ 272,337. Assets pledged as guarantee under the previous REFIS Program, in the amount of R\$ 249,034, continue to secure amounts under the PAES Program.

13. PENSION AND HEALTH BENEFIT PLANS**(a) Health benefit plan**

Managed by Fundação Sabesp de Seguridade Social - SABESPREV , the plan is comprised of free-election health benefit plans, funded by contributions from the sponsor and the participating employees, which were the following in the year:

Company: average of 7.00% (2005 - 6.89%) on the payroll;

Participating employees: 3.21% of base salary and bonus, corresponding to 2.3% of the gross payroll, on average.

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(b) Pension benefits

Managed by Fundação Sabesp de Seguridade Social - SABESP, the defined benefit pension plan is supported by monthly contributions as follows: 2.10% from the Company and 2.19% from the participating employees. In order to meet the provisions of CVM Resolution No. 371, of December 13, 2000, below is a description of the amounts of pension and retirement benefits paid granted and payable, to which the employees will be entitled after their service time.

Based on independent actuarial reports at December 31, 2006, calculated in conformity with the Projected Unit Credit Method, the Company had a net actuarial liability of R\$ 321,212 (R\$ 329,772 in 2005), representing the difference between the present value of the Company's liability to the participating employees, retired employees, and pensioners, of the related assets, as shown below:

(i) Reconciliation of assets and liabilities	2006	2005
Present value of actuarial liabilities	(1,096,219)	(790,552)
Fair value of plan assets	812,909	678,185
Gains to be recognized in future years	(37,902)	(217,405)
Net actuarial liability	(321,212)	(329,772)
Amortization of past service cost	-	53,214
Net liability recognized in the balance sheet	(321,212)	(276,558)
	2006	2005

(ii) Expenses recognized in the statements of income

Current service cost	17,545	9,889
Interest cost	93,270	91,886
Expected return on plan assets	(83,065)	(70,221)
Amortization (gain)/loss	(9,508)	(5,312)
Employee contributions	(15,411)	(13,752)
Amortization of past service cost	53,214	53,215
Total	56,045	65,705

(iii) Changes in net actuarial liabilities	2006	2005
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Present value of the net actuarial liability in the beginning of the year	(276,558)	(222,176)
Current service cost	(17,545)	(9,889)
Interest cost	(93,270)	(91,886)
Expected return on plan assets	83,065	70,221
Amortization (gain)/loss	9,508	5,312
Employee contributions	15,411	13,752
Amortization of past service cost	(53,214)	(53,215)
	(332,603)	(287,881)
Actual contributions by the Company in the year	11,391	11,323
Present value of net actuarial liability at the end of the year	(321,212)	(276,558)

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(iv) Reconciliation of changes in the present value of assets

Fair value of plan assets in the beginning of the year	678,185	584,702
Actual return on plan assets	138,444	98,667
Actual contributions in the year	26,802	25,076
Benefits paid	(30,522)	(30,260)
Fair value of plan assets at the end of the year	812,909	678,185

(v) Reconciliation of changes in the present value of liabilities

Present value of liabilities in the beginning of the year	790,552	760,015
Current service cost	17,545	9,889
Interest cost	93,270	91,886
Benefits paid	(30,522)	(30,260)
Loss (gain) in the present value of liabilities	225,374	(40,978)
Present value of liabilities at the end of the year	1,096,219	790,552

(vi) Estimated expenses

	2007	2006
Current service cost	33,440	17,545
Interest cost	131,848	93,270
Expected return on plan assets	(96,439)	(83,065)
Amortization (gain)/loss	-	(9,508)
Employees contributions	(12,925)	(15,411)
Amortization of past service cost	-	53,214
Total	55,924	56,045

(vii) Actuarial assumptions

Several statistical and other factors that attempt to project future events are used in calculating the expense and liability related to the plans. These factors include assumptions about the discount rate, expected return on plan assets and the rate of future salary increases as determined by the Company, within certain internal guidelines. In addition, the actuary also uses subjective factors such as termination, turnover and mortality rates to estimate these factors. The actuarial assumptions used by the Company are reviewed on a regular basis and may differ materially from actual

results due to changing market and economic conditions, regulatory events, judicial rulings, higher or lower termination/withdrawal rates or longer or shorter life spans of participants. Such differences may result in a significant impact on the amount of pension expense recorded by the Company.

The assumptions used for the actuarial valuation were as follows:

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Economic assumptions	2006	2005
Discount rate	12.32% a.a.	12.32% a.a.
Expected rate of return assets	12.06% a.a.	12.06% a.a.
Future salary increases	6.08% a.a.	6.08% a.a.
Growth in social security benefits and limits	4.00% a.a.	4.00% a.a.
Capacity factor		
- Salaries	98%	98%
- Benefits	98%	98%
Demographic assumptions for	2006	2005
Mortality table	AT 83	GAM 83
Disabled mortality table	RRB 1944	RRB 1944
Disability entry table	Modified RRB 1944	Modified RRB 1944
Turnover table	Prudential	Prudential
Retirement age	First age with entitlement to one of the benefits	First age with entitlement to one of the benefits
% active participants married at time of retirement	95%	95%
Age difference between participants and their spouses	Wives are 4 years younger than husbands	Wives are 4 years younger than husbands

For 2006 actuarial assessment, the general mortality table has been changed to AT-83 in replacement to GAM-1983 table reflects the increase in life expectancy of the population evaluated.

The number of active participants at December 31, 2006 and 2005 was 16,681 and 16,449 respectively. The number of inactive participants at December 31, 2006 and 2005 was 3,692 and 3,326 respectively.

The evaluation of SABESPREV costing plan is made by an independent actuarial expert, based on different assumptions than those adopted for purposes of ascertaining benefits to employees, as set forth in CVM Resolution no. 371. SABESPREV's technical deficit at December 31, 2006 is R\$ 491,391 (2005 - R\$ 456,861). Calculation is substantially different as for the actuarial method in calculating risk benefits before retirement, with sharing to SABESPREV and capitalization for the purpose of meeting CVM Resolution no. 371. Another significant difference is the discount rate of 6% for SABESPREV and 12.32% nominal rate for CVM Resolution no. 371, resulting from the combination of a long-term inflation rate of 4% per year and actual interest rate of 8%.

As permitted by CVM Resolution No. 371, the Company has elected to amortize the actuarial liability R\$ 266,074 at December 31, 2001 over five years using the straight-line method beginning in 2002. The amortization of the transition obligation for past service cost is being recorded as an Extraordinary Item, net of tax effects, in the statement of income for the year as follows:

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	2006	2006	2004
Extraordinary item	53,215	53,215	53,215
Deferred income and social contribution taxes	(18,093)	(18,093)	(18,093)
Net extraordinary item	35,122	35,122	35,122
Liabilities on December 31, 2001			266,074
Extraordinary item recorded for the period from 2002 to 2006			(266,074)

The Sponsor and the SABESPREV are in process of negotiation so that the technical deficit is resolved, by changing from the Defined Benefit Plan to Variable Contribution Plan. Management expects not to incur in additional costs resulting from the change of the referred plans.

14. PROFIT SHARING AND BONUS

As a result of negotiations held by the Company with entities representing the employees, a Profit Sharing Program was implemented. For 2005 it was considered the period from July 2005 to June 2006; for 2006, the period for goal assessment was changed to January through December, both with the payment of an amount corresponding to up to one month's payroll, in conformity with pre-established goals.

In December 2005 the Company made an advance payment of R\$ 22,906, equivalent to 50% of one month's payroll. The payment of the remainder was made in August 2006 in the amount of R\$ 25,082. The amount of R\$ 54,128, referring to the period from January through December 2006, was paid in February 2007.

In 2006, the accrued amount corresponds to one and a half month's payroll, in the amount of R\$ 79,489. The Company recorded additional salary and payroll charges in the amounts of R\$ 44,292 and R\$ 40,262, for the years ended December 31, 2005 and 2004, respectively

The Company paid in November, 2006, bonus of R\$ 31,035 referring to the performance evaluation for the year 2006.

15. PROVISIONS FOR CONTINGENCIES**(a) Provisions for contingencies:**

The Company is party to a number of claims and legal proceedings arising in the normal course of business, including civil, labor, environmental, tax and other matters. The Company has accrued amounts deemed by its legal counsels and its management to be enough to cover probable losses. As of December 31, 2006 and 2005, these provisions are as follow, in accordance with the nature of the respective cases:

2006	2005
------	------

Customer claims (i)	273,258	279,509
Contractor claims (ii)	168,547	194,357
Other civil claims (iii)	76,909	52,777
Tax claims (iv)	21,162	32,980

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Labor claims (v)	71,213	28,576
Environmental claims (vi)	65,988	24,198
Subtotal	677,077	612,397
Escrow deposits	(19,525)	(4,069)
Total, net of escrow deposits	657,552	608,328
Current portion	2,294	28,520
Non current portion	655,258	579,808

Changes to the provision for contingencies for the year ended in December 31, 2006 are demonstrated below:

	December			Interests, Monetary Adjustment and	December
	31,2005	Additions	Payments	Reversals	31, 2006
Customer claims	279,509	13,756	(18,592)	(1,415)	273,258
Contractor claims	194,357	1,819	(1,648)	(25,981)	168,547
Other civil claims	52,777	41,416	(23,152)	5,868	76,909
Tax claims	32,980	5,297	(17,229)	114	21,162
Labor claims	28,576	28,091	(4,244)	18,790	71,213
Environmental claims	24,198	45,370	(3,529)	(51)	65,988
Sub-total	612,397	135,749	(68,394)	(2,675)	677,077
Escrow deposits	(4,069)	(16,579)	1,123	-	(19,525)
Total	608,328	119,170	(67,271)	(2,675)	657,552

(b) Lawsuits with possible likelihood of loss

The lawsuits in course in administrative and judicial levels, in different courts, where the Company is the contrary party, considered by its legal counsels of possible likelihood of loss, not being, for this reason, provisioned in the financial statements, are distributed as follows:

2006	2005
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Customer claims (i)	789,300	690,000
Contractor claims (ii)	198,500	178,100
Other civil claims (iii)	141,600	116,900
Tax claims (iv)	104,900	246,300
Labor claims (v)	43,700	11,500
Environmental claims (vi)	192,400	211,200
Total	1,470,400	1,454,000

(c) Summary of claims and assessments

(i) Customer claims

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Approximately 980 customer claims were filed by business customers claiming that their tariffs should be equal to those of other categories of consumers and, consequently, claim the refund of amounts imposed and charged by the Company. The Company has obtained final decisions, both favorable and adverse, in several different court levels, and has recorded provisions for cases with probable risk of loss. In the year 2006, new customer claims were filed in the estimated amount of R\$ 46.5 million, as well as revisions and adjustments of already existing suits in the amount approximately of R\$ 52.8 million, for the cases assessed by the Company's legal counsels as possible loss.

Lawsuits from municipalities to which the Company provides water in a wholesale basis are not included (note 5 (a(iv))).

(ii) Contractor claims

Certain construction service contractors have filed claims in court alleging underpayment of monetary adjustments, withholding of amounts relating to the effects of the Real Plan and economic-financial unbalance of the contract. These lawsuits are in progress in several different court levels, and provisions are recorded for cases with probable chance of loss.

(iii) Other civil claims

The Company is party to several civil claims related to indemnities for moral and material damages and loss of profits allegedly caused to third parties. In December 31, 2006 provisions were recorded in the amount of R\$ 76,909 (R\$ 52,777 in 2005) for claims which risk of loss was assessed as probable.

(iv) Tax Claims

Provisions for contingencies of tax nature refer mostly to questions related to tax collection, questioned in view of divergence in interpretation of the legislation by the Company's legal counsels.

In 2006 the Federal Revenue Service, by means of a tax claim, verified the fulfillment, by the Company, of tax obligations related to the Income Tax of Legal Entities and Social Contribution on Net Profit for the fiscal year 2001, arriving at a tax credit of R\$ 277 million. The Company promptly filed its contest and shall appeal the tax assessment in all administrative and judicial court levels. According to its legal counsels, approximately 90% of this administrative lawsuit is considered as remote loss and 10% as possible loss.

The Company filed a writ of mandamus against the revocation of the exemption from service tax in the Municipality of São Paulo, occurred by means of municipal law enacted in 2002. In April 2003, the request for concession of preliminary injunction was granted determining the suspension of the taxation. In May 2005 the lower court published a decision denying the injunction. In July 2005, Sabesp filed appeals aiming at maintaining the effectiveness of the injunction granted. There has not been a final decision about the question. The amount involved is estimated in R\$ 70.0 million and the Company, based on its legal counsel's assessment, classifies the risk of loss as possible.

The Company filed claims against the City Hall of Bragança Paulista and São Paulo due to the imposition of tax on the use of public areas for the installation of water and sewage networks related to the sanitation services provided to the municipalities. In the lawsuit filed against the City Hall of Bragança Paulista, a preliminary injunction has been granted to the Company suspending the imposition of this charge and preventing the City Hall from charging any current or future amounts with respect to this charge until there is a final decision of the merits of the cause. In June 2005, the Lower Court ruled in favor of the Company and the injunction was maintained. The City Hall appealed against such decision, which is still pending a trial decision. With regards to the claim filed against the City Hall of São Paulo, the First Level Court issued a decision upholding the legality of this municipal tax. The Company appealed against the court's decision. An approved law enacted the tax on use of public areas in the city of São Paulo. In April 2004, the Company filed a request for injunction seeking the suspension of the assessment by the municipality. The preliminary injunction was granted by the First Level Court and confirmed at the occasion of the pronouncement of the sentence, recognizing the collection to be undue. The City Hall filed an appeal recourse and awaits a decision by the superior court. The Company, based on its legal counsel assessment, has not recorded any provision resulting from this municipal tax.

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We are a party to a series of lawsuits initiated by the municipality of Ferraz de Vasconcelos in 1997, seeking payment of penalties in the aggregate amount of R\$71.9 million, which we allegedly owe for damages caused during construction in the municipality. Several of these lawsuits have already been rejected by lower courts but are still subject to appeal. We have not made any provisions for these proceedings.

(v) Labor claims

The Company is party to a number of labor proceedings, such as matters referring to overtime, health hazard, premium claims, prior notice period, job deviation, salary parity and others, with a major portion of the amounts claimed under provisional or final execution stage, in several different court levels, and thus are classified as probable loss, and duly provisioned for.

On January 9, 1990, SINTAEMA initiated a lawsuit against us, alleging that we had failed to pay certain employee benefits and were required to make a penalty payment to SINTAEMA under a then existing collective bargaining agreement. On July 31, 1992, the labor court issued a ruling against us, but did not award damages to SINTAEMA at that time. We and SINTAEMA are currently engaged in negotiations concerning the amount to be paid by us. We also filed a writ of mandamus seeking a court decision establishing that the penalty imposed against us, totaling approximately R\$6.7 million, as of December 31, 2006, is excessive since it exceeds the principal amount by a large margin. Our request was denied by the courts and the lawsuit is now awaiting a final decision at the Superior Labor Court (Tribunal Superior do Trabalho). We currently cannot predict the amount that we will be required to pay to SINTAEMA and we have not made any provisions for this proceeding.

On October 6, 1989, SINTAEMA filed a lawsuit against us, asking for the payment of salary differences arising from additional payments due to unhealthy work conditions from September 1987 through February 1991. On December 19, 1997, the Superior Labor Court issued a decision contrary/unfavorable to Sabesp. We appealed against this decision, however, the decision was kept/maintained by the Superior Labor Court. SINTAEMA started the enforcement of the judicial decision and the valuation report of the technical expert of the court was presented on February 21, 2007 in the updated amount of R\$28.3 million. Our internal legal counsel considered the risk of loss as probable and the amount was provisioned on December 31, 2006.

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(vi) Environmental Claims

Environment claims refer to several administrative proceedings brought by public agencies, including Companhia de Tecnologia de Saneamento Ambiental - CETESB (Environment Sanitation Technology Company), seeking to impose fine for environmental damages allegedly caused by the Company.

Among other matters involving the State of São Paulo Public Attorney's Office, the following are worthy of mention:

(A) On April 4, 2002, the Company was served process in a public action filed by the District Attorney's Office of the Municipality of São Bernardo do Campo, aiming at repairing damages caused by reason of the mud discharge arising from the waste treatment facilities of the Company in current waters, as well as requesting the interruption of such discharge. An injunction has been granted determining that the Company suspended the mud discharge and assessing a daily fine in the amount of R\$ 50 in case the Company does not comply with the provision of such injunction; however, such injunction was withdrawn. The trial court rendered an affirmative judgment to the Company, against which an appeal has been filed. The superior court decided against the Company and ordered it to stop dumping waste within one year from the date the decision is considered final, or to pay a daily fine of R\$ 10, in addition to repairing the environmental damage caused. The Company legal counsels assessed the risk of loss as probable and the provision recorded represents the amount of R\$ 141 reflecting the amount attributed to the cause; (B) Civil Public Action before the Paraguaçu Paulista courts of law (1ª Vara de Paraguaçu Paulista) seeking compensation and cessation of environmental damages allegedly caused by discharge of sewage in natura by the Company in Alegre River, located in the Municipality of Paraguaçu Paulista. The first instance judge ruled against the Company, requiring that it: (i) ceases the release of raw sewage into the Alegre River; (ii) invests in a water and sewage treatment facility in the municipality of Paraguaçu Paulista; and (iii) pays an indemnity for environmental damages arbitrated in the amount of R\$ 116.9 million (the adjusted amount, as of December 31, 2006, was approximately R\$ 168.9 million). The court decision determined, further, that the non-compliance with items (i) and/or (ii) above would subject the Company to the payment of daily fines. The Company filed an appeal against the trial court decision; however, the works necessary to meet items (i) and (ii) above have their conclusion estimated to October 2007. On September 21, 2006, the Court of Justice of the State of São Paulo ruled against the Company's appeal. Although the unfavorable decision by the Court of Justice of the State of São Paulo is not definitive, the Company is negotiating with the Public Prosecution Office of the State of São Paulo the terms and conditions of an agreement that shall result in the extinction of the legal suit. The first deals of the agreement resulted in an expectancy of future disbursements in the amount of R\$ 20.7 million. In the last quarter of 2006, the basis of the agreement was expanded, being included new projects, which total the provision in the amount of R\$ 33.6 million; (C) Civil Public Action against the Company and the Municipality of Cotia aiming at their mutual condemnation: (a) to the obligation to make consisting of interrupting the disposal of sewage into Cotia River under penalty of daily fines; (b) in the obligation to make it consistent and submit to previous treatment all sewages before their discharging into Cotia River, under penalty of daily fine and (c) to pay indemnities for environmental damages caused to the soil, hydric resources, superficial and underground bodies of water that cannot be recovered. The First Level Court accepted the requests (a) and (c). In the decision settlement, the amount calculated by the judicial expert was R\$ 5.8 million as indemnification for environmental damages, an amount that is still under discussion and pending to be set up by the First Level Court. The Company's legal counsels assessed the risk of loss as probable; (D) on February 25, 2003, a request for a preliminary injunction was filed for the Company to immediately refrain itself from disposing of sewage without due treatment, in the

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municipality of Lutécia, as well as for the purpose of determining that payments for water and sewage services by users thereof be deposited in court until the Company has fulfilled the necessary plan of investments in the water and sewage system of the municipality, in addition to daily fine in the amount of one thousand (1,000) minimum salaries (approximately R\$ 350) in case of non-compliance with the award-making decision. After submission of an expert report, the Public Prosecutor Office requested the Company to be sentenced to pay the amount of R\$ 82.8 million (the adjustment amount, as of December 31, 2006, was approximately R\$ 119.6 million). The Company, considering the possibility of an eventual settlement with the Public Prosecutor Office, condemned the area and requested the respective environment licenses, being that its legal counsels assessed the risk of loss as possible; (E) in February 17, 2003 a civil public action has been filed before the Paraguaçu Paulista Courts referring to the municipality of Borá, of obligation to do and not do consisting of not discharging and let it be thrown, in any way, sewage without due treatment into Borá Brook, or in any other one in the municipality, as well as the obligation to do, consisting of investing into the sewage and water treatment system, performing immediately the necessary works for the proper sewage treatment. The anticipated tutelage has been denied. The judicial expert presented as indemnification for environmental damages the updated amount of R\$ 48.1 million. The Company's technical assistant presented impugnation to the expert's report and there is still no decision. The Company carried out the works requested by Cetesb, in order to adequate the treatment to the legislation in force. Cetesb, after monitoring, has issued the Operating Permit under Provisional Title in August 25, 2006, valid until August 25, 2011. The Company's legal counsels assessed the risk of loss as possible; (F) A civil public action was brought against us by the Coordination Council for the Civil Entities of Piracicaba (Conselho Coordenador das Entidades Cíveis de Piracicaba) concerning the limits for water collection from the Piracicaba River and the operation of the Cantareira water distribution system. The plaintiff requests, among other things, a prohibitory injunction in order to restrict the amount of water we collect, the reduction of the Piracicaba River's collection limit and the payment of damages to the riparian cities in order to cover the direct and indirect environmental damages caused by the installation and operation of the Cantareira water distribution system. After our defense, the injunction was not granted, and this action is now awaiting judgment by the lower court. This proceeding is still at an initial stage and no amount has been determined so far for the alleged damage. We have not made any provisions for this proceeding.

The Company is involved in other environmental processes in municipalities where we operate, arising from the discharge of waste without treatment, assessed as probable and possible risk of loss by our legal counsels. The amounts provisioned do not always represent the final amount to be disbursed as indemnification for alleged damages, taking into account the status in which the referred lawsuits are and Management's impossibility to estimate the amounts of future disbursements in a reasonable way. On December 31, 2006 the total provisioned represents the amount of R\$ 65,988 already contemplating those described on items (A), (B) and (C).

(vii) Other proceedings related to the Concession

In connection with discussions we had with the municipality of Presidente Prudente, we filed a claim against the municipality seeking a court decision determining the continuation of the concession contract that we have entered into with that municipality until the indemnification payment owed to us in connection with the return of water and sewage treatment facility of Presidente Prudente is made. The lower court issued a decision in our favor to the effect

that we still continue to provide services in the municipality until the indemnification provided for in the concession contract is paid to us.

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On March 25, 2004, the Public Attorney's Office filed a civil action against the municipality of Itapira, its mayor, the Municipal House of Representatives and us, claiming that Municipal Law No. 3,593/04 is unconstitutional and seeking termination of the concession contract we entered into with the municipality of Itapira. Although an injunction was granted, the Court of Justice of the State of São Paulo has stayed the injunction. On March 23, 2005, the House of Representatives of Itapira approved a decree revoking the concession contract. In addition, Municipal Law No. 3,730/05 was enacted revoking an earlier law which authorized the municipality to enter into the concession contract with us. The municipality of Itapira has further filed an action against us seeking to repossess the assets related to its water and sewage services and has obtained an injunction which was later confirmed by a court decision. We appealed against this ruling but we have not been able to suspend the effects of the decision until final judgment. Accordingly, we are currently not rendering water and sewage services at Itapira. As of the date of this annual report, a trial decision on this litigation was pending. We have not made any provisions for this proceeding.

On October 10, 2003, the municipality of Monte Mor filed a lawsuit against us, seeking the additional issuance and delivery of shares by us, as consideration for our concession to render basic water and sewage services. The lawsuit was dismissed without judgment on the merits of the case. We have not made any provisions for this proceeding.

The municipality of Sandovalina has brought a legal action against us seeking to (1) obtain the termination of the concession entered into with us and (2) obtain remedies for environmental damage and alleged losses caused to the municipality due to our failure to provide sewage treatment, as well as other damage caused to public property. We have responded with a counterclaim against the municipality for payment of R\$115 related to the supply of water from December 1999 through August 2003. We are also seeking the payment of a contractual indemnification based on the early termination of the contract. We are currently operating the water and sewage treatment facility of Sandovalina, and the lawsuit is still in the fact-finding phase. We have not made any provisions for this proceeding.

We are also defendants in legal proceedings initiated by municipalities seeking to require us to produce documents and information in connection with our concessions. These legal proceedings include the following: (1) a preliminary proceeding (ação cautelar) started by the municipality of Guariba seeking a court order requiring us to produce documents in order to inform an account revision proceeding; (2) the municipality of Ribeirão Pires has proposed preliminary proceedings seeking the production of documents to inspect the services which we provide; (3) the municipalities of Itupeva and Monte Mor have proposed proceedings seeking to obtain a court order to require us to produce documents and information in order to evaluate the possibility of renewal of our concession agreement.

In December 1997, the municipality of Santos enacted a law expropriating our water and sewage systems in Santos. In response, we filed an action seeking an injunction against this expropriation, which was denied by the lower court. This decision was later reversed by the Court of Justice of the State of São Paulo, which issued a preliminary order suspending that law. On August 2, 2002, a decision on this matter was rendered in our favor by a lower court, but that decision remains subject to appeal. Despite the pending lawsuit, we continue to provide water and sewage services to Santos.

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We are a party to a substantial number of other legal proceedings, in addition to the lawsuits and administrative proceedings discussed above, in the normal course of our business. These legal proceedings include personal injury and property damage cases, environmental proceedings, challenges to our ability to cease rendering water and sewage services upon default by our customers and a range of other matters. We have not established provisions with respect to these other legal proceedings.

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16. SHAREHOLDERS EQUITY**(a) Authorized capital**

The Company is authorized to increase its capital up to a maximum of R\$ 4,100,000 registered common shares without par value, upon resolution of the board of directors.

The Company has from time to time issued shares to purchase assets from third parties, usually municipal authorities. These shares are issued at market value, which correspond to the fair value of the assets acquired.

(b) Subscribed and paid-up capital

Subscribed and paid-up capital is represented by 28,479,577,827 registered common shares without par value as follows:

Shareholders	2006		2005	
	Number of shares	%	Number of shares	%
Secretaria da Fazenda	14,313,511,867	50.26	14,313,511,871	50.26
Companhia Brasileira de Liquidação e Custódia	7,722,535,287	27.11	7,708,472,937	27.06
The Bank Of New York ADR Department (Equivalent to stock)(*)	6,415,657,250	22.53	6,430,069,500	22.58
Other	27,873,423	0.10	27,523,519	0.10
	28,479,577,827	100.00	28,479,577,827	100.00

(*) each ADR equals 250 shares

(c) Distribution of earnings

Shareholders are entitled to a mandatory minimum dividend distribution of 25% of adjusted net income, calculated in conformity with Brazilian Corporate Law. This requirement can be met through payments made in the form of dividends and interest on shareholders' equity (net of withholding tax), to the extent amounts are available for distribution. Dividend distributions are limited to retained earnings as determined in accordance with BR CL. At December 31, 2006, as required by the CVM, management designated the retained earnings balance to a discretionary investment reserve account (see (e) below).

For purposes of BR CL, and in accordance with the by-laws of the Company, adjusted annual net income is an amount equal to the Company's annual net income adjusted to reflect allocations to or from (i) statutory legal reserve, (ii) an equity contingency reserve for anticipated losses, if any, and (iii) an unrealized revenue reserve, if any. The calculation of the mandatory minimum dividends for 2006 is as follows:

Net income for the year	778,905
(-) Legal reserve 5%	38,946
Net income	739,959

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Mandatory minimum dividend	184,988
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The Company by-laws also provide for distribution of interest on shareholders' equity as an alternative form of distribution to shareholders. The interest rate is limited to the variation in the TJLP during the applicable period and the deductible distribution cannot exceed the greater of 50% of net income (before distribution and deductions for income taxes) for the period or 50% of retained earnings. Distribution of interest on shareholders' equity is a tax-deductible expense for both income tax and social contribution purposes. The amount paid to shareholders as interest on shareholders' equity, net of any withholding tax, is taken into account in determining the mandatory dividend.

The Company declared interest on shareholders' equity, in lieu of dividends, in the amount of R\$ 251,238, net of withheld income tax in the amount of R\$ 19,603 in 2006. In 2005, the amount was R\$ 324,461 net of income tax of R\$ 23,755. Interest on shareholders' equity was calculated in conformity with article 9 of Law No. 9.249/95, at the Long-Term Interest Rate (TJLP); this interest was originally recorded in Financial expenses for income and social contribution tax purposes and subsequently, for presentation purposes, was reflected directly in Shareholders' equity.

The amounts due to the major shareholder relating to the years 2004 to 2006 have not been paid, as mentioned in note 6.

(d) Capital reserves

Capital reserve comprises tax incentives and donations from government agencies and private entities, which amounted to R\$ 27,870 during the year 2006 (R\$ 13,529 in 2005).

The tax incentive reserve results from an option to invest in the capital stock of companies undertaking specified government-approved projects. In lieu of paying part of the income tax due, the amount is credited to income tax and subsequently appropriated from retained earnings to this reserve.

The donations reserve reflects the value of assets received from government entities, principally enabling the Company to provide service access to properties. No shares are issued in exchange nor other remuneration provided in connection with assets received. These donations are recorded as a direct benefit to shareholders' equity.

(e) Investment reserve

Management proposed to transfer the balance of retained earnings not distributed to shareholders to a discretionary reserve (investment reserve) in accordance with the Company's capital expenditure program.

The following summarizes the allocation of net income to the investment reserve for the years ended December 31,

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	2006	2005
Net income	778,905	865,647
(+) Revaluation reserve realization	102,272	89,449
(-) Interest on own capital	270,841	348,216
(-) Legal reserve 5%	38,946	43,282
Investment reserve	571,390	563,598

Management will propose to transfer the balance of retained earnings in the amount of R\$ 571,390 to the Investment Reserve account in order to meet the needs for investments out of own funds, as provided for in the Capital Budget.

(f) Legal (statutory) reserve

Under Brazilian Corporate Law, the Company is required to record a legal reserve to which it must allocate 5% of the adjusted net income each year until the amount of the reserve equals 20% of paid-in capital. Accumulated deficit, if any, may be charged against the legal reserve.

17. INSURANCE COVERAGE

Insurance policies held by the Company provide the following coverage, taking into account the risks and nature of the related assets:

Type of insurance	Insured amount - R\$	Premium
Engineering risk	281,884	669
Fire	294,691	325
Civil liability - officers and employees	80,000	3,219
Civil liability - construction in progress	9,438	403
Civil liability - operations	1,500	160

The Company does not have insurance coverage for business interruption risks nor for liabilities arising from contamination or other problems involving the supply of water to customers. In addition, the Company does not have insurance coverage for liabilities relating to non-compliance with environmental laws and regulations.

18. FINANCIAL INSTRUMENTS AND RISK

(a) Valuation of Financial Instruments

In accordance with CVM Instruction No. 235/95, the Company has determined the market values of its assets and liabilities based on available information and appropriate valuation methodologies. Market values and book values of the Company's financial instruments at December 31, 2006 and 2005 are as follows:

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	December 31, 2006			December 31, 2005		
	Book value	Market value	Unrealized gain	Book value	Market value	Unrealized gain
Financial investments	248,088	248,088	-	155,718	155,718	-
(i)						
Debentures						
(ii)	(1,309,265)	(1,010,003)	(299,262)	(918,367)	(955,630)	37,263
Loans and financing	(508,955)	(523,300)	14,345	(526,658)	(604,315)	77,657
(ii)						
	(1,570,132)	(1,285,215)	(284,917)	(1,289,307)	(1,404,227)	114,920

The main financial instruments, assets or liabilities of the Company, on December 31, 2006 are described as follows, as well as their valuation criteria:

(i) Financial Investments: The market value of these assets does not differ from the amounts demonstrated in the Company's balance sheets.

(ii) Loans, Financings and debentures (5th issue, 2nd series; 6th issue, 2nd and 3rd series and 7th and 8th issues, 2nd series), with financial instruments with the same characteristics in the market, had the market value determined based on the discounted cash flow, using interest rates projections available. The remain loans and financings were not marked to market either for being financial instruments with exclusive characteristics (without corresponding ones in the market) or for which no material difference between the market value and the book value exist, as they are indexed to the CDI which is a floating rate used in the market.

(b) Exchange rate risks

Exchange rate risk is the risk that the Company may incur losses due to exchange rate fluctuations, which could increase the liability balances and related financial expenses of loans and financing denominated in foreign currencies funded in the market and, consequently, the financial expenses. The Company does not enter into hedge or swap transactions, however, at times, it enters into forward exchange transaction and financial funding transactions to mitigate foreign currency exposure, taking advantage of opportunities in order to exchange them for less expensive debts, reducing the cost by means of advancing maturities.

A significant portion of the Company's debt is denominated in foreign currency, primarily the US dollar and the Yen, totaling R\$ 1,472,768 (note 10). The Company's net exposure to the exchange rate risk at December 31, 2006 is summarized as follows:

In thousands

	December 31, 2006		December 31, 2005	
	US\$	Yens	US\$	
Loans and financing	676,142	652,814	666,890	1,020

(c) Interest rate risks

This risk arises out of the possibility for the Company to incur losses due to interest rates fluctuations that would increase its financial expenses related to loans and financing. The Company has not entered into hedge agreements to mitigate such risk. The Company does, however, continually monitors market interest rates in order to evaluate the possible need to replace or refinance its debt. On December 31, 2006, the Company had loans and financing in the amount of R\$ 1,283,197 (R\$ 1,327,694 in 2005), at variable interest rates (CDI and TJLP).

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Another risk faced by the company is that the monetary adjustments of its debts are not correlated to the accounts receivable. The Company's related water and sewage tariff rates are not necessarily correlated with the increases in the interest rates and price-level restatement indexes associated with the Company's debt.

(d) Credit Risk

The Company manages credit risk principally by selling to a geographically dispersed customer base, including sales to municipal governments.

No single customer represented more than 10% of the Company's sales and services rendered in the years ended December 31, 2006, 2005, and 2004.

(e) Drought weather risk

The atypical meteorological conditions for the past three years, resulted in the need to launch institutional campaigns to encourage economical and rational use of water, which has led to a decrease in billed water volumes. At the same time, higher investments were required to mitigate the drought effects on the Company's water production systems. This drought period has required a reduction in water supply, with a consequent reduction in water volumes billed. In view of the present levels of the reservoirs, no rationing is estimated to occur in 2006.

19. GROSS REVENUE

	2006	2005	2004
Metropolitan São Paulo	4,534,093	4,044,191	3,456,837
Regional systems	1,449,919	1,312,135	1,185,654
Total	5,984,012	5,356,326	4,642,491

(i) Comprises the municipalities served in the country side and coastal area of the State of São Paulo

In October 2003, the Company launched a new campaign "Watch the Water Level", involving advertisements in all media, together with a program consisting of discounts to customers who reduce their water consumption for the period from March to September 2004, by at least 20%, in relation to the average consumption determined by the Company. The Incentive Program for Water Consumption Reduction was implemented in the Metropolitan Region of São Paulo.

The program resulted in a reduction of R\$ 74.1 million in the revenue from water and sewage services in the Metropolitan Region of São Paulo during its effective period.

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20. OPERATING EXPENSES

	2006	2005	2004
Cost of sales and services:			
Salaries and payroll charges	966,751	851,290	806,362
General supplies	117,872	105,333	84,489
Treatment supplies	104,466	98,823	91,450
Outsourced services	326,422	297,469	260,423
Electric power	446,974	421,319	396,940
General expenses	32,560	29,840	35,044
Depreciation and amortization	621,719	572,301	578,672
	2,616,764	2,376,375	2,253,380
Selling expenses:			
Salaries and payroll charges	159,094	142,685	138,180
General supplies	5,276	6,632	6,028
Outsourced services	80,467	82,354	66,956
Electric power	768	941	802
General expenses	58,946	46,636	46,025
Depreciation and amortization	2,716	3,291	2,952
Bad debt expense, net of recoveries (note 5(c))	411,918	255,292	241,577
	719,185	537,831	502,520
Administrative expenses:			
Salaries and payroll charges	132,554	112,458	110,388
General supplies	4,574	3,973	3,527
Outsourced services	79,379	94,153	94,825
Electric power	1,119	1,250	904
General expenses	118,646	88,027	60,936
Depreciation and amortization	17,736	20,389	17,287
Tax expenses	33,399	29,334	25,690
	387,407	349,584	313,557
Total costs of sales and services, selling and administrative and expenses:			
Salaries and payroll charges	1,258,399	1,106,433	1,054,930
General supplies	127,722	115,938	94,044
Treatment supplies	104,466	98,823	91,450
Outsourced services	486,268	473,976	422,204

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Electric power	448,861	423,510	398,646
General expenses	210,152	164,503	142,005
Depreciation and amortization	642,171	595,981	598,911
Tax expenses	33,399	29,334	25,690
Bad debt expense, net of recoveries	411,918	255,292	241,577
	3,723,356	3,263,790	3,069,457
Financial expenses:			
Interest and other charges on loans and financing - local currency	517,547	526,585	448,955
Interest and other charges on loans and financing - foreign currency	121,194	141,844	218,900
Interest on shareholders' equity (note 16 (e))	270,841	348,216	152,935
Interest on shareholders' equity (reversal)	(270,841)	(348,216)	(152,935)

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	2006	2005	2004
Other expenses on loans and financing	7	1,825	282
Income tax on remittances abroad	12,564	9,450	(23,786)
Other financial expenses	38,642	35,574	41,126
Monetary variations on loans and financing	86,594	80,411	76,057
Other monetary and foreign exchange variations	10,937	1,611	21,257
Provisions	(2,675)	76,482	38,483
	784,810	873,782	821,274
Financial income:			
Monetary variation	28,475	34,803	60,636
Income from financial investments	50,882	32,292	23,114
Sale of third parties shares	207	-	-
Interest	46,383	48,368	57,552
COFINS and PASEP (taxes on financial income)	-	-	(3,101)
Other	-	44	1
	125,947	115,507	138,202
Financial result, net	658,863	758,275	683,072
Foreign exchange, net			
Exchange variations on loans and financing	(96,071)	(312,116)	(179,697)
Foreign exchange income	473	845	331
	(95,598)	(311,271)	(179,366)

21. MANAGEMENT COMPENSATION

Compensation paid by the Company to the members of its board of directors and Management totaled R\$ 3,084, R\$ 2,104 and R\$ 1,838 for the years ended December 31, 2006, 2005 and 2004, respectively.

22. COMMITMENTS

(i) Operating leases

Administrative operating leases and property leases already contracted require the following minimum payments, as follows:

2007	6,568
2008	3,494
2009	270
2010	4
2011	58
TOTAL	10,394

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Lease expenses for the years ended December 31, 2006, 2005 and 2004 were R\$ 9,810, R\$ 9,505 and R\$ 11,300, respectively.

(ii) Take-or-pay contracts

The Company has entered into long-term take-or-pay-contracts with electric power providers. The main amounts of contracts of such type are shown as follows:

2007	209,506
2008	177,333
2009	167,616
2010	169,548
2011	175,009
2012	146,244
TOTAL	1,045,256

Electric power expenses for the years ended December 31, 2006, 2005 and 2004 were R\$ 449,089, R\$ 423,814 and R\$ 398,744, respectively.

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23. SUMMARY OF DIFFERENCES BETWEEN BR CL AND US GAAP

The Company's primary financial statements have been prepared in accordance with BR CL which differs significantly from US GAAP as described below:

(a) Inflation accounting methodology and indices

In Brazil, because of highly inflationary conditions which prevailed in the past, a form of inflation accounting had been in use for many years to minimize the impact of the distortions in financial statements caused by inflation. Two methods of inflation accounting were developed: one required under BR CL; and the other known as the Constant Currency Method. The primary difference between BR CL and the Constant Currency Method relates to accounting for the effects of inflation. Under BR CL, inflation accounting was discontinued effective January 1, 1996. Prior to that date, BR CL required inflationary indexation of property, plant and equipment, investments, deferred charges and shareholders' equity, the net effect of which was reported in the statement of operations as a single line item. The Constant Currency Method is similar to U.S. Accounting Principles Board Statement No. 3 ("APB 3"), except that the former continues to apply inflationary accounting in periods of low inflation. Under US GAAP, the Brazilian economy ceased to be highly inflationary effective July 1, 1997. The other significant difference between the two sets of principles relates to the present-value discounting of fixed-rate receivables and payables, which is required by the Constant Currency Method and is prohibited under BR CL.

Financial statements prepared in accordance with BR CL have been, and continue to be, required of all Brazilian corporate entities and are used by the Brazilian tax authorities in determining taxable income. Financial statements prepared in accordance with the constant currency method were required through 1995 for those entities whose securities were registered with the CVM. Since 1996, presentation of supplemental financial statements under the Constant Currency Method has been optional.

(i) Additional inflation restatement in 1996 and 1997 for US GAAP

In the reconciliation from BR CL to US GAAP, consistent with the position paper prepared by the U.S. AICPA International Practice Task Force, an adjustment for inflation accounting has been included for the period from January 1, 1996 to December 31, 1997. During this period, inflation accounting was prohibited by BR CL but was required by APB statement 3 under US GAAP. Shareholders' equity under US GAAP was increased by R\$ 1,171,576 and R\$ 1,247,117 at December 31, 2006 and 2005, respectively, due to the additional inflation restatement adjustments.

(ii) Supplementary inflation restatement replaces revaluation of property, plant and equipment for US GAAP

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The price-level restatement methodology under BR CL relied on an official inflation index announced by the Brazilian Federal government which was also used for purposes of determining taxes payable. Shortly after the launch of an economic stabilization plan in 1990, the government announced an inflation rate for that year which was materially understated in relation to the general and consumer price indexes as measured by independent economic institutes. In 1991, the government acknowledged this distortion and companies were required to re-present their statutory financial statements using a revised inflation index and the effects thereof were also used to determine income taxes, retroactively. The same law (Law No. 8,200/91) also granted companies the option (and the CVM required adoption when the effects were significant) to reprocess the accumulated inflation accounting effects since the date of acquisition of assets based on an independently sourced consumer or general price index. This supplemental indexation of property, plant and equipment, investments and deferred charges was to be recorded in the statutory BR CL accounting books but would have no effect for tax purposes. The Company anticipated the effects of this measure by contracting an independent firm of experts to perform an appraisal to market value of its property, plant and equipment and recorded the revaluation increment in its statutory BR CL accounting records, without affecting its tax position, in much the same way as Law No. 8,200/91 later required. As the revaluation increment had eliminated the effects of the supplemental price-level restatements, no further action was taken and the Company did not apply the incremental indexation.

Under US GAAP, revaluations of assets to market value are not permitted and the effects of the revaluation have been reversed in the reconciliation to US GAAP. However, in order to preserve the integrity of the historical cost of its assets based on the price-level restatement convention adopted by BR CL, the Company has recorded the supplemental price-level restatement adjustments, in accordance with Article 2 of Law No. 8,200/91, as an adjusting item in the reconciliation to US GAAP. The Company has presented the balances of shareholders' equity and net income under BR CL, adjusted for the effects of the revaluation and the replacement of the reversal by the supplemental price-level restatements, and related tax effects, as a subtotal, prior to presenting the reconciling items to US GAAP. The subtotal also includes the effects of including an additional two years' inflation accounting adjustments through to 1997 for purposes of US GAAP.

Shareholders' equity under US GAAP was increased by R\$ 2,806,638 and R\$ 2,924,881 at December 31, 2006 and 2005, respectively, due to the supplementary inflation restatement adjustments and reduced by R\$ 2,427,499 and R\$ 2,529,771 at December 31, 2006 and 2005, respectively, due to the reversal of the revaluations, before tax effects.

(iii) Inflation indexes

The indexation of the financial statements through 1995, except for the year 1990, under BR CL was based on an official government index, the *Unidade Fiscal de Referência* - UFIR and for the year ended December 31, 1990 on a consumer price index (*Índice de Preços ao Consumidor*, or IPC). For purposes of US GAAP, a general price index, the *Índice Geral de Preços - Mercado*, or IGP-M, was used to record the additional inflation restatement in 1996 and 1997 and the supplementary inflation restatement through 1995.

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(b) Income taxes and social contribution

Under BR CL, deferred tax assets are recognized at the estimated amounts that management considers are probable to be recovered. In addition, deferred income taxes are shown gross rather than net.

Under US GAAP, deferred taxes are recorded on all temporary tax differences. Valuation allowances are established when it is more likely than not that deferred tax assets, including tax loss carryforwards, will not be recovered. Deferred tax assets and liabilities are classified as current or long-term based on the classification of the asset or liability underlying the temporary difference, and are presented net.

For purposes of deferred tax accounting, the US GAAP adjustments relating to inflation restatement of land and the push-down expenses from the Plan G0 pension fund (j)(ii) below and sabbatical paid leave benefits are treated as permanent tax differences, as such items are not deductible for tax purposes by the Company.

Taxes on income in Brazil consist of two types of taxes: income tax and social contribution. In Brazil, the tax law and tax rates are sometimes significantly altered by provisional measures ("*medidas provisórias*") announced by Presidential decree. The provisional measures can affect tax rates as well as other areas that could impact deferred taxes. Until September 2001, these measures remained in force for one month and expired automatically if they were not extended for an additional one-month period. In September 2001 all provisional measures were automatically enacted, and the Presidential decree powers restricted. Under BR CL, when calculating deferred income taxes, the provisional measures are usually taken into account.

Under US GAAP, only enacted tax rates may be used to calculate deferred taxes. Tax rates for future periods which have been established by provisional measures are not considered to have been enacted and are ignored. However, the provisional measure, to the extent it has not lapsed, is used for determining the amount of current tax payable.

Shareholders' equity under US GAAP was reduced by R\$ 1,356,545 and R\$ 1,304,723 at December 31, 2006 and 2005, respectively, due to deferred tax adjustments on US GAAP differences, excluding revaluations and permanent differences related to monetary readjustment on land of approximately R\$ 150.0 million.

No valuation allowance adjustments were required to be included in the reconciliation between BR CL and US GAAP.

(c) Financial instruments and concentration of credit risk

Under BR CL, there are less detailed requirements regarding the disclosure of information on financial instruments not reflected on the balance sheet or on concentration of financial instruments with credit risk.

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Under US GAAP, the applicable accounting practice for financial instruments depends on management's intention for their disposition and requires adjustments to their market or fair values. Additional information on face or contract or notional principal amount; nature and terms including (i) credit and market risk, (ii) cash requirements and (iii) accounting policy followed; amount of loss, if any party to the financial instrument fails to perform; and policy as to requiring collateral is required. Disclosure as to concentration of credit risk arising from all financial instruments is required to include information about the activity, region or other characteristic that identifies the concentration; amount of loss if parties to the concentrated risk fail to completely perform; and policy as to requiring collateral.

Statement of Financial Accounting Standards ("SFAS") No. 133, "Accounting for Derivative Instruments and Hedging Activities" of the U.S. Financial Accounting Standards Board (FASB) establishes accounting and reporting standards for derivative instruments and for hedging activities. It requires that an entity recognize all derivatives as either assets or liabilities and measure those instruments at fair value. This statement was effective January 1, 2001 and did not have a significant impact on the Company's financial statements.

No adjustments have been included in the reconciliation from BR CL to US GAAP.

(d) Cash and cash equivalents

Under BR CL, cash equivalents are not defined.

Under US GAAP, SFAS No. 95, "Statement of Cash Flows", defines cash equivalents as short-term highly liquid investments that are both (i) readily convertible to known amounts of cash and (ii) so near their maturity that they present insignificant risk of changes in value because of changes in interest rates. Generally, only investments with original maturities of three months or less qualify under that definition. The Company holds certain highly liquid, low risk financial investments, comprised principally of high quality government debt, which are classified as cash equivalents under BR GAAP. Although the investments have high level of liquidity and present insignificant risks of changes in value, under US GAAP, since these investments have original maturities of over 90 days, such investments do not qualify as cash equivalents. The effect of this difference in classification on the Company's balance sheets and statements of cash flows for the periods presented are as follows:

	2006	2005
		(restated)
Cash and cash equivalents under Brazilian GAAP	328,206	280,173
Difference in classification of temporary investments	-	(155,783)
Cash and cash equivalents under US GAAP	328,206	124,390
Cash Flows	2006	2005
	(restated)	(restated)

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Operating activities under Brazilian GAAP	2,020,824	1,737,575	1,441,095
Cash flows relating to short-term investments under US GAAP	155,783	(99,815)	108,588
Operating activities under US GAAP	2,176,607	1,637,760	1,549,683

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Cash and cash equivalents at beginning of the year under Brazilian GAAP	280,173	105,557	281,013
Difference in classification of temporary investments at beginning of the year	(155,783)	(55,968)	(164,556)
Cash and cash equivalents at beginning of the year under US GAAP	124,390	49,589	116,457
Increase in cash and cash equivalents under Brazilian GAAP	48,033	174,616	(175,456)
Cash flows relating to short-term investments under US GAAP	155,783	(99,815)	108,588
Cash and cash equivalents at end of year under US GAAP	328,206	124,390	49,589

(e) Investments in debt and equity securities

Under BR CL, marketable debt and equity securities are generally stated at the lower of inflation-indexed amortized cost or market value less interest or dividends received. Gains and losses are reflected in earnings.

Under US GAAP, in accordance with SFAS No. 115, "Accounting for Certain Investments in Debt and Equity Securities", the accounting and reporting for investments in equity securities that have readily determinable fair values and for all investments in debt securities is as follows:

- (i) Debt securities that the enterprise has the positive intent and ability to hold to maturity are classified as held-to-maturity securities and are reported at amortized cost.
- (ii) Debt and equity securities that are bought and held principally for the purpose of selling them in the near term are classified as trading securities and reported at fair value, with unrealized gains and losses included in earnings.
- (iii) Debt and equity securities not classified as either held to maturity or trading securities are classified as available for sale securities and reported at fair value, with unrealized gains and losses excluded from earnings and reported in a separate component of shareholders' equity.

For purposes of US GAAP, certain unrealized gains and losses from the Company's available-for-sale securities are recorded directly in shareholders' equity, net of tax effects, until realized. Shareholders' equity under US GAAP was reduced by R\$ 93 and R\$ 30 at December 31, 2006 and 2005, respectively, for unrealized losses from available-for-sale securities.

(f) Property, plant and equipment

- (i) Revaluations of property, plant and equipment

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BR CL permits appraisal write-ups, provided that certain formalities are complied with. The revaluation increment is credited to a reserve account in shareholders' equity. Depreciation of the asset revaluation increments is charged to income and an offsetting portion is relieved from the revaluation reserve in shareholders' equity and transferred to retained earnings as the related assets are depreciated or are disposed

For US GAAP reconciliation purposes, net revaluation of property, plant and equipment in the amounts of R\$ 2,427,499 and R\$ 2,529,771 at December 31, 2006 and 2005, respectively, have been eliminated in order to present property, plant and equipment at historical cost, indexed for inflation through 1997 based on a general price index, less accumulated depreciation. The depreciation on such revaluation charged to income, totaling R\$ 102,272, R\$ 89,449 and R\$ 104,500 for the years ended December 31, 2006, 2005 and 2004, respectively, has also been eliminated for US GAAP purposes in the reconciliation of net income.

Under BR CL, no deferred tax liability was recorded on the revaluation increment. Under US GAAP, although the depreciation from the additional inflation restatement ((a)(i) above) and the supplementary inflation restatement ((a)(ii) above) will not be deductible for tax purposes, these depreciation charges are considered to be temporary tax differences as the expense will reverse through income in the future, and, as such, are recorded for purposes of determining deferred tax liabilities.

(ii) Different criteria for capitalizing and depreciating capitalized interest

Under BR CL, until December 31, 1995, capitalization of interest cost incurred during the construction period as part of the cost of the related property, plant and equipment was not required. However, as permitted by the Brazilian Water and Sewage Plan (*Plano Nacional de Saneamento Básico* - PLANASA), SABESP capitalized interest on construction-in-progress through 1989. Also, under BR CL as applied to companies in the utilities industry, during the period from 1979 to 1985, a notional interest rate was applied to construction-in-progress computed at the rate of 12% per annum of the balance of construction-in-progress; that part which related to interest on third-party loans was credited to interest expense based on actual interest costs with the balance relating to the self-financing portion being credited to capital reserves. Beginning in 1999, SABESP has capitalized indexation charges on the real - denominated loans and financing and the foreign exchange effects on foreign currency loans and financing.

Under US GAAP, in accordance with SFAS No. 34, "Capitalization of Interest Cost", interest incurred on borrowings is capitalized to the extent that borrowings do not exceed construction-in-progress. Such interest is capitalized as part of the cost of the related assets with a corresponding credit to financial expenses. Under US GAAP, the amount of interest capitalized excludes the indexation charges associated with the borrowings and the foreign exchange gains and losses on foreign currency borrowings.

The effects of these different criteria for capitalizing and amortizing interest are presented below:

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	2006	2005
Interest capitalized under US GAAP in the period from 1989 to 1995	206,227	208,826
Amortization thereof	(105,964)	(100,222)
Capitalized interest credited to income under BR CL (12% per annum, applied monthly to the balance of construction-in progress) in excess of actual interest	(32,569)	(32,983)
Amortization thereof	29,188	28,285
Indexation charges and foreign exchange losses capitalized since 1999 under BR CL, net	50,576	27,528
US GAAP difference in shareholders' equity at December 31	147,458	131,434
US GAAP difference on pre-tax income for the year ended December 31	16,024	25,929

(iii) Valuation of long-lived assets

Under BR CL, companies are required to determine if operating income is sufficient to absorb the depreciation or amortization of long-lived assets, within the context of the balance sheet as a whole, in order to assess potential asset impairment. As it pertains to property, plant and equipment, in the event that such operating income is insufficient to recover the depreciation due to their permanent impairment, the assets, or groups of assets, are written-down to recoverable values, preferably, based on the projected discounted cash flows of future operations.

Under US GAAP, SFAS No. 144, "Accounting for the Impairment or Disposal of Long-lived Assets", requires companies to periodically evaluate the carrying value of long-lived assets to be held and used, and for long lived assets to be disposed of, when events and circumstances require such a review. The carrying value of long-lived assets is considered impaired when the anticipated undiscounted cash flows from identified assets, representing the lowest level for which identifiable cash flows largely independent of the cash flows of other groups of assets and liabilities, is less than their carrying value. In that event, a loss is recognized to the extent that the carrying value exceeds the fair market value of the assets.

No adjustment has been included in the reconciliation from BR CL to US GAAP to take account of differences between the measurement criteria, as based on analysis of cash flows measured at the smallest unit of assets groups for which cash flow data is captured no impairment provisions were required. Losses recognized on the write-off of property, plant and equipment arose primarily from adjustments related to the withdrawal of concession assets, construction-in-progress projects which were deemed to be no longer economically feasible and obsolescence write offs.

(g) Deferred charges

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Under BR CL deferral of feasibility study costs and pre-operating expenses incurred in the construction or expansion of a new facility is permitted until such time as the facility begins commercial operations. Deferred charges are amortized over a period of five to ten years.

Under US GAAP, such amounts do not meet the conditions established for deferral and accordingly are charged to income as incurred.

The balance of feasibility study costs outstanding, amounted to R\$ 10,035 and R\$ 20,531 at December 31, 2006 and 2005, respectively, was written-off for US GAAP purposes. The net effects from amortization and deferrals in the statement of operations at December 31, 2006, 2005 and 2004 were an increase of R\$ 10,496, R\$ 18,566 and R\$ 9,854 respectively.

(h) Dismissal encouragement program

In December 2003 the Company announced a one-time, special dismissal encouragement / early retirement program. Under BR CL, the total estimated termination benefits for all employees who would formally accept the offer were accrued for at December 31, 2003. Under US GAAP, such benefits are considered special termination benefits, as defined in SFAS No. 88, "Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits" and as such, are only allowed to be accrued as an expense when an employee accepts the offer. At December 31, 2003, approximately 330 employees had requested to apply to enter the dismissal encouragement program. In the reconciliation between BR CL and US GAAP, the difference between the estimated benefits under BR CL and the estimated benefits associated with those employees who had accepted offers at December 31, 2003 has been reversed for US GAAP. Such benefits were accrued and expensed in 2004. At December 31, 2004, 711 employees entered this program and the Company had paid R\$ 29,409.

(i) Pension benefits

Under BR CL, prior to 2002, amounts related to the pension plan were recorded on an accrual basis as the obligations for contributions fell due. In accordance with a new accounting standard issued by IBRACON and approved by the CVM, effective January 1, 2002, Brazilian public companies must account for pension obligations based on actuarial calculations and provide certain disclosures related to their pension plans. Under the new standard, the actuarial pension obligation determined at the date of adoption could be either recorded directly in shareholders' equity, or prospectively, during the five-year period ending December 31, 2006 in results of operations. As permitted, the Company has elected to recognize this transition obligation on a straight-line basis through income over five years beginning in 2002. The amortization of the liability is being presented as an Extraordinary item in the statements of operations, net of applicable tax effects.

Under US GAAP, the Company accounts for its pension plans in accordance with the provisions of SFAS No. 87, "Employers' Accounting for Pensions," which among other requirements, requires that the Company recognize the actuarially-determined liability of its pension plan obligations. SFAS No. 87 also requires that an additional liability (minimum pension liability) is required to be recorded when the accumulated benefit obligation exceeds the fair value of the plan assets, less accrued pension amounts. This additional minimum liability is recorded as a charge to

accumulated other comprehensive income in equity.

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SFAS No. 132 (revised 2003), Employers' Disclosures about Pensions and Other Postretirement Benefits sets forth the requirements for information that must be disclosed with respect to the Company's pension plans.

After the issuance of SFAS 158 Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans an amendment of FASB Statements No. 87, 88, 106, and 132(R), in September 2006, an employer is required to recognize the overfunded or underfunded status of a defined benefit postretirement plan (other than a multi-employer plan) as an asset or liability in its statement of financial position and to recognize changes in that funded status in the year in which the changes occur through comprehensive income of a business entity or changes in unrestricted net assets of a not-for-profit organization. This Statement also requires an employer to measure the funded status of a plan as of the date of its year-end statement of financial position, with limited exceptions.

Another requirement of the statement is that the employer must disclose in the notes to financial statements additional information about certain effects on net periodic benefit cost for the next fiscal year that arise from delayed recognition of the gains or losses, prior service costs or credits, and transition asset or obligation. An employer with publicly traded equity securities is required to initially recognize the funded status of a defined benefit postretirement plan and to provide the required disclosures as of the end of the fiscal year ending after December 15, 2006.

The additional adjustments required by the SFAS 158 has been made after the accounting according to the SFAS 87 and SFAS 132.

Although the adopted accounting standard under BR CL requires the Company to recognize pension obligation based on actuarial methods effective January 1, 2002, differences under BR CL related to the prescribed actuarial methods, date of first adoption and amortization of transition obligations, among others, as compared with those under US GAAP, generate reconciling adjustments for US GAAP purposes.

(i) Pension plan (Plan G1)

The Company sponsors a defined-benefit plan for its employees (Plan G1). For the purposes of calculating the funded status of Plan G1, the provisions of SFAS No. 87, were applied with effect from January 1, 1992, because it was not feasible to apply them from the effective date specified in the standard.

(ii) Supplementary pension plan (Plan G0)

Pursuant to a law enacted by the State Government, certain employees who provided service to the Company prior to May 1974 and retired as an employee of the Company acquired a legal right to receive supplemental pension payments (which rights are referred to as Plan G0). The Company pays these supplemental benefits on behalf of the State Government and makes claims for reimbursement from the State Government, which are recorded as accounts receivable, shareholder under BR CL. No expense is recognized for these benefits under BR CL.

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Consistent with the guidance in SEC Staff Accounting Bulletin Topic 5-T ("SAB No. 5-T"), under US GAAP, the Company recognizes the costs and obligations associated with Plan G0 supplemental pension benefits incurred by the State Government on behalf of the Company with respect to its employees on a push-down basis, as the Company is the recipient of the benefits of the employee service for which the supplemental pension benefits are made. These benefits are accounted for in accordance with SFAS No. 87. Eventual amounts received as reimbursement from the State Government, if any, are treated as additional paid-in-capital.

Retained earnings was reduced in the first year of presentation (1998) for the actuarial liability computed under SFAS No. 87. and the balance of amounts due from the State Government for pensions paid was charged to income, as this amount relates to a charge for past services rendered by the Company's former employees. Amounts reimbursed to the Company by the State Government were accounted for as additional paid-in capital and a reduction of the actuarial liability to reflect gross benefits paid. The remaining unpaid reimbursable balance due from the State Government (effectively a subscription receivable) was charged off as a deduction to shareholders' equity.

(iii) Sabbatical paid leave

The Company also pays amounts equivalent to three months of vacation for each five years' of service as a form of sabbatical paid leave to certain of the Company's employees for which it also claims reimbursement from the State Government. Consistent with the guidance in SAB Topic 5-T, under US GAAP the Company recognizes the costs and obligations associated with these sabbatical leave benefits incurred by the State Government on behalf of the Company with respect to its employees on a push-down basis, as the Company is the recipient of the benefits of the employee service for which the supplemental pension benefits are made. The Company has accounted for this sabbatical expense by relieving directly against retained earnings for the first year presented and subsequently the Company recognized as a charge to income the receivable due from the State Government, for sabbatical leave paid, as this amount relates to a charge for past services rendered by the Company's former/current employees. Amounts reimbursed by the State Government, if any, are accounted for as additional paid-in capital.

During the year ended December 31, 2000, in the financial statements prepared in accordance with BR CL, sabbatical leave accruals totaling R\$ 23,747, which had in prior years been charged to income, and were accounted for as a receivable (reimbursement) due from the State Government, were reversed, as the Company does not consider this to be an expense under BR CL. Similarly, during December 31, 2006, 2005 and 2004, total amounts not accrued were R\$ 1,991, R\$ 968 and R\$ 14,743, respectively. Such amounts, consistent with the US GAAP difference mentioned above, were pushed down as expenses in the reconciliation to US GAAP.

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(iv) Summary of pension benefits adjustments

The effects included in the shareholders' equity reconciliation arising from these different criteria for pension and benefit accounting are presented below:

	2006	2005
Plan G1		
Accrued pension liability under US GAAP (SFAS 87)	(644,760)	(585,637)
Accrued pension liability under BR CL	321,212	276,558
Difference Plan G1 (SFAS 87)	(323,548)	(309,079)
Incremental Effect of Applying SFAS N° 158	361,450	
Difference Plan G1	37,902	(309,079)
Plan G0		
Accrued pension cost under US GAAP (SFAS 87)	(1,156,492)	(1,130,511)
Incremental Effect of Applying SFAS N° 158	(87,575)	-
Difference Plan G0	(1,244,067)	(1,130,511)
Sabbatical paid leave		
Recognition of reversed expense (i) (iii)	(8,565)	(10,556)
Push-down accounting of Plan G0 and sabbatical paid leave		
Gross amount paid for Plan G0 and sabbatical paid leave recorded as receivables from the State Government (i)	(889,425)	(787,684)
Additional paid-in capital - Plan G0 and sabbatical paid leave reimbursed by the State Government (i)	114,970	114,970

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The effects included in the reconciliation of net income (los) arising from these different criteria for pension and benefit accounting are presented bellow:

	2006	2005	2004
Plan G1			
Accrued pension obligation Plan G1	(14,469)	45,163	41,617
Plan G0			
Accrued pension obligation Plan G0	(25,981)	(27,258)	(37,148)
Sabbatical paid leave			

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	2006	2005	2004
Recognition of reversed expense	1,991	968	14,743
Push-down accounting of Plan G0 and sabbatical paid leave			
Gross amount paid for Plan G0 and sabbatical paid leave recorded as receivables from the State Government	(101,741)	(96,388)	(85,340)

(j) Capitalization of debt issuance costs

Under BR CL the costs associated with issuance of debts are recognized as a operational expenses. Under US GAAP, APB 21 Interest on Receivables and Payables debt issue costs are deferred and amortized using the effective interest method over the remaining term of the applicable debt obligations. At December 31, 2006, the balance of deferred debt issue costs included as an adjustment to shareholders equity, related to debt issue costs was R\$ 11,331 (in 2005 was R\$ 13,976), net of accumulated amortization.

(k) Donations

Under BR CL these amounts, which comprise principally contributions of property, plant and equipment that we receive from third parties, were recorded at fair value, generally determined based on estimates of the current replacement cost of the assets contributed, as a revenue until December 31, 2003 an as a credit to other capital reserves after this date.

For U.S. GAAP purposes, the amounts recorded as revenues and capital reserves related to donations received from third parties would be classified as a deferred credit, recorded as a reduction of the related amount of property, plant and equipment in the balance sheet, and amortized to reduce depreciation expense over the related estimated useful life of the donated assets. Prior to 2006, we did not account for any differences between BR CL and US GAAP, as the amounts of such donations have not historically been, and were not expected to be material. However, in light of the cumulative nature of such donations, beginning January 1, 2006, we began accounting for such differences.

As a result, shareholders equity under U.S. GAAP was lower by R\$ 69,535, net of tax effects, as compared to BR CL at December 31, 2006. Net income in 2006 was also lower by R\$15,871, net of tax effects, as compared to BR CL, as a result of the cumulative differences in the accounting for donations under BR CL. The related impacts on prior year results of operations were not material.

(l) Segment reporting

Under BR CL, no separate segment reporting is required.

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Under US GAAP, SFAS No. 131, "Disclosures about Segments of an Enterprise and Related Information" establishes the standards for the manner in which public enterprises are required to report financial and descriptive information about their operating segments. SFAS No. 131 defines operating segments as components of an enterprise for which separate financial information is available and evaluated regularly as a means for assessing segment performance and allocating resources to segments. A measure of profit or loss, total assets and other related information are required to be disclosed for each operating segment.

The Company operates in two segments: water services and sewage services.

(m) Comprehensive income

BR CL does not embody the concept of comprehensive income.

Under US GAAP, the Company has adopted the provisions of SFAS No. 130, "Reporting Comprehensive Income." A foreign (i.e., non-U.S.) registrant may present the statement of comprehensive income in any format permitted by SFAS No. 130. The information required by SFAS No. 130, has been included in the condensed financial statement information as prepared in accordance with US GAAP below.

(n) Provision for dividends and interest on shareholders' equity

Under BR CL, at each annual balance sheet date management is required to propose a dividend distribution from earnings and accrue for this in the financial statements. Under BR CL, companies are permitted to distribute a notional amount of interest, subject to certain limitations, calculated based on the government TJLP interest rate, on shareholders' equity. Such amounts are deductible for tax purposes and are presented as a deduction from shareholders' equity. Although not affecting net income except for the tax benefit, in certain cases companies include this notional charge in interest expense and reverse the same amount before totaling net income. The Company presents the financial expense net of the reversal in its financial statements.

Under US GAAP, since proposed dividends must be ratified or modified at the annual shareholders' meeting, dividends would generally not be considered as declared at the balance sheet date and, as such, would not be accrued. However, because the State Government is the Company's controlling shareholder, the minimum dividend proposal when made by management at year end is maintained as a provision, and therefore, no adjustments has been included in the reconciliation from BR CL to US GAAP. Interim dividends paid or interest credited to shareholders as interest on shareholders' equity under BR CL is considered as declared for US GAAP purposes. Under US GAAP, no similar interest distribution concept exists.

Distributions per share data (in the form of dividends or interest on shareholders' equity) is not required to be disclosed under BR CL.

Interest on shareholders' equity per thousand common shares for the years ended December 31, 2006, 2005 and 2004 were as follows:

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	December 31,		
	2006	2005	2004
Interest on shareholders' equity per shares	1.19	1.53	0.67

(o) Related parties

Under BR CL, related parties are generally defined in a more limited manner and require fewer disclosures than US GAAP. The Company has expanded its disclosure for purposes of BR CL.

No adjustments have been included in the reconciliation from BR CL to US GAAP.

(p) Items posted directly to shareholders' equity accounts

Under BR CL, various items are posted directly to shareholders' equity accounts. Examples include certain capitalized interest, the effects of adjustments to tax rates and tax incentive investment credits received. As noted in (a) above, Brazilian utility companies used to capitalize interest attributable to construction-in-progress at the rate of 12% per annum of the balance of construction-in-progress and that part which relates to interest on third-party loans is credited to interest expense based on actual interest costs with the balance relating to the self-financed portion being credited to capital reserves.

Under US GAAP, such items relating to third-party debt would be posted to the statement of operations. Since the original posting to equity accounts would, under US GAAP, be made directly to the statement of operations, these adjustments are included in the reconciliation of shareholders' equity and net income determined in accordance with US GAAP.

(q) Discounting

Under BR CL, discounting of trade receivables and payables to present value is not permitted. Under US GAAP, APB No. 21 "Interest on Receivables and Payables", such discounting, in certain cases, is required to record the effects of implicit interest income or expense or which are different from market rates on long-term assets and liabilities, except for transactions in which interest rates are affected by the tax attributes or legal restrictions prescribed by a government agency. The company does not have original long term agreements.

No adjustments have been included in the reconciliation from BR CL to US GAAP as the Company had no long-term trade accounts payables or receivables potentially subject to discounting at December 31, 2006, 2005 and 2004.

(r) Classification of statement of operations line items

Under BR CL, as noted above, the classification of certain income and expense items is presented differently from US GAAP. The Company has recast its statement of operations under BR CL to present a condensed statement of operations prepared in accordance with US GAAP. The reclassifications are summarized as follows:

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- (i) Interest income and interest expense, together with other financial charges, are displayed within operating income in the statement of operations presented in accordance with BR CL. Such amounts have been reclassified to non-operating income and expenses in the condensed statement of operations prepared in accordance with US GAAP.
- (ii) Under BR CL, gains and losses on the disposal or impairment of permanent assets are classified as non-operating income (expense). Under US GAAP, gains and losses on the disposal or impairment of property, plant and equipment are classified as an adjustment to operating income.
- (iii) Following the issue of a new accounting standard under BR CL, effective January 1, 2002, the Company is amortizing the related transition obligation related to Plan G1 over five years. The related amortization, as permitted, is being presented as an Extraordinary item net of taxes, in the statement of operations. Under US GAAP, this amortization expense would be included as part of operating income.

(s) Earnings per share

Under BR CL, net income per share is calculated on the number of shares outstanding at the balance sheet date. Information is disclosed per lot of one thousand shares, because this is the minimum number of shares of the Company that can be traded on the stock exchanges.

Under US GAAP, in accordance with SFAS No.128, "Earnings per Share", the presentation of earnings per share is required for public companies, including earnings per share from continuing operations and net income per share on the face of the statement of operations, and the per share effect of changes in accounting principles, discontinued operations and extraordinary items either on the face of the statement of operations or in a note. A dual presentation is required: basic and diluted. Computations of basic and diluted earnings per share data are based on the weighted average number of shares outstanding during the period and all potentially dilutive shares outstanding during each period presented, respectively.

Statement 128 requires the retroactive restatement of earnings-per-share computations for stock dividends, stock splits, and reverse splits. If a stock dividend or split is consummated after the close of the period but prior to the issuance of the financial statements, the earnings-per-share computation should be based on the new number of shares.

The Board of Directors, in its meeting on March 30, 2007, approved the proposal for submission to the Annual Shareholders Meeting, which took place on April 30, 2007, of the Grouping of Shares. On June 4, 2007, the shares were grouped in the proportion of 125 (one hundred twenty five) shares to 1 (one) share. The capital stock is represented by 227,836,623 common nominative and scriptural shares, without par value, remaining unchanged Sabesp's capital stock.

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Simultaneously to the grouping operation, the American Depositary Receipts (ADR s) started to be traded in the proportion of 2 (two) shares to each ADR.

Considering the grouping of shares mentioned above the weighted-average number of shares used in computing basic earnings per share for December 31, 2006, 2005 and 2004 was 227,836,623. The Company had no potentially dilutive shares outstanding during 2006, 2005 or 2004.

(t) Financial statement note disclosures

BR CL requires, in general, less information to be disclosed in the notes to the financial statements than US GAAP. The additional disclosures required by US GAAP which are relevant to these financial statements are included in this Note 23, 24 and 25.

(u) Leasing Transactions

Under Brazilian GAAP, generally, lessees account for long-term leases as operating leases, whereas in accordance with U.S. GAAP such leases could be accounted for as operating or capital leases. As a result, under Brazilian GAAP, lease payments by lessees with respect to leases are charged as an expense as incurred. Under U.S. GAAP, the lease payments may be charged as an expense as incurred (operating leases) or the leased asset and the corresponding lease liability may be recognized in the balance sheet and the effect of depreciation and interest expense in the results of operations (capital leases).

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*Net income (loss) reconciliation of the differences between BR CL and US GAAP****The following is a reconciliation of the differences in net income (loss) between BR CL and US GAAP:***

		2006	2005	2004
Net income as reported under the BR CL		778,905	865,647	513,028
Depreciation of additional inflation restatement in 1996 and 1997	(a) (i)	(75,541)	(61,955)	(70,251)
Reversal of depreciation of revaluation increments	(f) (i)	102,272	89,449	104,500
Depreciation of supplementary restatement prior to 1991	(a) (ii)	(118,243)	(103,420)	(120,820)
Deferred tax effects on above (excluding revaluation)	(b)	65,887	56,228	64,964
Net income as reported under the BR CL, adjusted for inflation restatements and revaluations		753,280	845,949	491,421
Accrued pension cost - Plan G1	(i)	(14,469)	45,163	41,617
Accrued supplementary pension cost - Plan G0	(i)	(25,981)	(27,258)	(37,148)
Sabbatical leave benefits	(i)	1,991	968	14,743
Actuarial liability (Plan G0) and sabbatical leave benefits push-down recognition	(i) (f)	(101,741)	(96,388)	(85,340)
Capitalized interest	(ii)	16,024	25,929	17,934
Interests on Capital Leasing	(u)	6,967	(645)	
Deferred charges, net of effects of accumulated amortization	(g)	10,496	18,566	9,854
Capitalization of debt issuance costs	(j)	(2,645)	13,976	
Deferred Credits - Donations	(k)	(26,622)		
Dismissal Encouragement Program	(h)	-	-	(18,113)
		617,300	826,260	434,968
Deferred income taxes effects:				
Other GAAP differences above, excluding reversal of revaluation increments	(b)	5,184	(35,016)	(17,439)

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Net income under US GAAP		622,484	791,244	417,529
Net income per thousand common shares				
Basic and diluted (in reais)	(s)	2.73	3.47	1.83
Weighted average number of common shares				
outstanding on December 31,				
2006	(s)	227,836,623	227,836,623	227,836,623

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*Shareholders' equity reconciliation of the differences between BR CL and US GAAP**The following is a reconciliation of the differences in shareholders' equity between BR CL and US GAAP:*

		2006	2005
Shareholders' equity, as reported under BR CL		9,018,482	8,482,548
Add (deduct):			
Additional inflation restatement in 1996 and 1997, net	(a) (i)	1,171,576	1,247,117
	(a)		
	(i)/		
Reversal of revaluation increments, net	(f) (i)	(2,427,499)	(2,529,771)
	(a)		
Supplementary restatement prior to 1991, net	(ii)	2,806,638	2,924,881
Deferred tax effects on above (excluding revaluation)	(b)	(1,301,684)	(1,367,571)
Shareholders' equity, as reported under BR CL, adjusted for inflation restatements and revaluations		9,267,513	8,757,204
Accrued pension cost - Plan G1	(i)	37,902	(309,079)
Accrued supplementary pension cost -Plan G0	(i)	(1,244,067)	(1,130,511)
Actuarial liability (Plan G0) and sabbatical leave expense push-down recognition	(i)	(889,425)	(787,684)
Additional paid-in capital - Plan G0 and sabbatical expense reimbursed by the State Government	(i)	114,970	114,970
Sabbatical paid leave of absence benefits	(i)	(8,565)	(10,556)
	(f)		
Capitalized interest	(ii)	147,458	131,434
Interests on Capital Leasing	(u)	6,322	(645)
Deferred charges expensed, net	(g)	(10,035)	(20,531)
Capitalization of debt issuance costs	(j)	11,331	13,976
Deferred Credits - Donations	(k)	(80,286)	
Other GAAP differences	(e)	(93)	(30)
Deferred income taxes effects:			
Other deferred tax effects on US GAAP differences above, excluding adjustments for available-for-sale securities, inflation restatements and revaluation increments		(54,861)	62,848

Shareholders' equity under US GAAP	7,298,164	6,821,396
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Supplemental Condensed Financial Statement Information in Accordance with US GAAP.

The following presents condensed financial statement information in accordance with US GAAP.

	2006	2005
<i>Assets</i>		
Current assets		
Cash and cash equivalents	328,206	124,390
Short term investments	-	155,783
Customer accounts receivable, net	1,111,289	1,069,098
Receivables from shareholder, net	367,864	292,507
Inventories	48,889	36,070
Taxes recoverable	31,582	853
Other current assets	28,852	26,915
Total current assets	1,916,682	1,705,616
Investments	627	710
Intangible assets concession rights, net	495,118	502,518
Property, plant and equipment, net	15,473,542	15,393,916
Other long-term assets		
Customer accounts receivable, net	296,562	263,356
Receivables from shareholder, net	89,012	127,880
Escrow deposits	33,835	23,857
Indemnities receivable	148,794	148,794
Other assets	44,525	43,151
	612,728	607,038
Total assets	18,498,697	18,209,798

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	2006	2005
Liabilities and shareholders' equity		
Current liabilities		
Accounts payable to suppliers and contractors	144,167	77,781
Loans and financing	852,475	759,013
Accrued payroll and related charges	177,705	117,289
Deferred income taxes	69,281	47,378
Taxes payable	105,552	106,131
Accrued pension obligation		
Plan G0	110,059	
Provisions for contingencies	2,294	28,520
Interest on shareholders' equity	511,519	409,725
Services Received	152,953	107,660
Other current liabilities	99,312	103,621
Total current liabilities	2,225,317	1,757,118
Long-term liabilities		
Loans and financing	5,459,938	5,905,208
Taxes payable	230,440	256,114
Accrued pension obligation		
Plan G0	1,134,008	1,130,511
Plan G1	283,310	585,637
Provisions for contingencies	655,258	579,808
Deferred income taxes	1,160,792	1,139,346
Other liabilities	51,470	34,660
Total long-term liabilities	8,975,216	9,631,284
Commitments and contingencies		
Shareholders' equity		
Paid-in capital	3,518,658	3,518,658
Capital reserves	53,026	78,820
Supplementary and additional inflation restatement reserves	3,978,214	4,171,998
Accumulated other comprehensive income net of taxes	150,982	
Appropriated earnings	254,219	215,273
Accumulated deficit	(656,935)	(1,163,353)

Total shareholders' equity	7,298,164	6,821,396
Total liabilities and shareholders' equity	18,498,697	18,209,798

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Condensed Statements of Operations in accordance with US GAAP

	2006	2005	2004
Gross revenue from sales and services	5,984,012	5,356,326	4,642,491
Taxes on sales and services	(456,679)	(402,963)	(245,419)
Net revenue from sales and services	5,527,333	4,953,363	4,397,072
Cost of sales and services	(2,822,616)	(2,570,180)	(2,443,965)
Gross profit	2,704,717	2,383,183	1,953,107
Operating expenses			
Selling	(737,303)	(555,435)	(521,532)
Administrative	(428,670)	(350,180)	(324,119)
Other operating expenses, net	(87,380)	(7,356)	(34,465)
Income from operations	1,451,364	1,470,212	1,072,991
Financial expenses, net	(542,266)	(401,894)	(479,243)
Income before taxes on income	909,098	1,068,318	593,748
Income and social contribution taxes	(286,614)	(277,074)	(176,219)
Net income for the year	622,484	791,244	417,529
Net income per thousand shares Basic and diluted (in reais)	2.73	3.47	1.83
Weighted average number of common shares outstanding	227,836,623	227,836,623	227,836,623

Condensed Statement of Comprehensive Income (Loss) in accordance with US GAAP (under SFAS No. 130)

	2006	2005	2004
Net income for the year	622,484	791,244	417,529
Unrealized gains (losses) on available-for-sale securities	(63)	62	7

Comprehensive income	622,421	791,306	417,536
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COMPANHIA DE SANEAMENTO BÁSICO DO ESTADO DE SÃO PAULO - SABESP**NOTES TO THE FINANCIAL STATEMENTS**

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Condensed Statement of Changes in Shareholders' Equity in accordance with US GAAP.

	2006	2005	2004
Balance at beginning of the year	6,821,396	6,364,777	6,085,624
Donations	(25,794)	13,529	14,552
Unrealized gains (losses) on available-for-sale securities	(63)	62	7
Effects of Applying SFAS N° 158:			
Pension Plan - Plan G1	238,557	-	-
Pension Plan - Plan G0	(87,575)	-	-
Net income for the year	622,484	791,244	417,529
Interest on shareholders' equity	(270,841)	(348,216)	(152,935)
Balance at end of the year	7,298,164	6,821,396	6,364,777

Recently Issued Accounting Pronouncements

The Financial Accounting Standard Board (FASB) has issued some accounting pronouncements and interpretations, but neither of the standards or interpretations had impacted materially the Financial Statements of the company as described below:

In February 2006, the FASB issued Statement No. 155, Accounting for Certain Hybrid Financial Instruments, an amendment of FASB Statement No. 133 and 140 (SFAS 155), which permits fair value measurement for any hybrid financial instrument that contains an embedded derivative that otherwise would require bifurcation, with changes in fair value recognized in earnings. The fair-value election will eliminate the need to separately recognize certain derivatives embedded in hybrid financial instruments under FASB Statement No. 133, Accounting for Derivative Instruments and Hedging Activities. SFAS 155 is effective for all financial instruments acquired or issued after the beginning of the first fiscal year that begins after September 15, 2006. The adoption of the pronouncement is not expected to have a material effect to SABESP financial statements.

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In March 2006, the FASB issued SFAS No. 156, "Accounting for Servicing of Financial Assets". SFAS 156 amends SFAS No. 140, "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities", which establishes, among other things, the accounting for all separately recognized servicing assets and servicing liabilities. SFAS 156 amends Statement 140 to require that all separately recognized servicing assets and servicing liabilities be initially measured at fair value, if practicable. SFAS 156 permits, but does not require, the subsequent measurement of separately recognized servicing assets and servicing liabilities at fair value. An entity that uses derivative instruments to mitigate the risks inherent in servicing assets and servicing liabilities is required to account for those derivative instruments at fair value. Under this Statement, an entity can elect subsequent fair value measurement to account for its separately recognized servicing assets and servicing liabilities. An entity shall adopt this Statement as of the beginning of its first fiscal year that begins after September 15, 2006. Earlier adoption is permitted in certain cases. The impact of adopting this new rule is dependent on events that could occur in future periods, and as such, an estimate of the impact cannot be determined until the event occurs in future periods.

In June 2006, the FASB issued Interpretation No. 48, Accounting for Uncertainty in Income Taxes, An Interpretation of SFAS No. 109, (FIN 48). FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with SFAS No. 109, Accounting for Income Taxes. FIN 48 requires that realization of an uncertain income tax position must be more likely than not (i.e., greater than 50% likelihood of receiving a benefit) before it can be recognized in the financial statements.

Further, this interpretation prescribes the benefit to be recorded in the financial statements as the amount most likely to be realized assuming a review by tax authorities having all relevant information and applying current conventions. Additionally, FIN 48 provides guidance on derecognition, income statement classification of interest and penalties, accounting in interim periods, disclosure, and transition. This interpretation is effective for fiscal years beginning after December 15, 2006. SABESP is currently evaluating the effect the application of FIN 48 will have on its financial statements.

In September 2006, the FASB issued Statement No. 157, Fair Value Measurements (SFAS 157). SFAS No.157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. SFAS No. 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. The transition adjustment, which is measured as the difference between the carrying amount and the fair value of those financial instruments at the date this statement is initially applied, should be recognized as a cumulative effect adjustment to the opening balance of retained earnings for the fiscal year in which this statement is initially applied. SABESP is currently evaluating the effect the application of SFAS No. 157 will have on its financial statements.

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In September 2006, the Securities and Exchange Commission ("SEC") issued Staff Accounting Bulletin 108, Considering the Effects on Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements ("SAB 108"). SAB 108 requires registrants to quantify errors using both the income statement method (i.e. iron curtain method) and the rollover method and requires adjustment if either method indicates a material error. If a correction in the current year relating to prior year errors is material to the current year, then the prior year financial information needs to be corrected. A correction to the prior year results that are not material to those years would not require a restatement process where prior financials would be amended. SAB 108 is effective for fiscal years ending after November 15, 2006. The Company has assessed SAB 108 and has concluded that it did not have a material effect on its financial position, results of operations or cash flows.

In September 2006, the FASB issued SFAS No. 158, Employers Accounting for Defined Benefit Pension and Other Postretirement Plans an amendment of FASB Statements No. 87, 88, 106, and 132(R) .

The SFAS 158 requires an employer to recognize the overfunded or underfunded status of a defined benefit postretirement plan (other than a multi-employer plan) as an asset or liability in its statement of financial position and to recognize changes in that funded status in the year in which the changes occur through comprehensive income of a business entity or changes in unrestricted net assets of a not-for-profit organization. This Statement also requires an employer to measure the funded status of a plan as of the date of its year-end statement of financial position, with limited exceptions.

Another requirement of the statement is that the employer must disclose in the notes to financial statements additional information about certain effects on net periodic benefit cost for the next fiscal year that arise from delayed recognition of the gains or losses, prior service costs or credits, and transition asset or obligation. An employer with publicly traded equity securities is required to initially recognize the funded status of a defined benefit postretirement plan and to provide the required disclosures as of the end of the fiscal year ending after December 15, 2006. The adoption of the pronouncement has impacted the SABESP's financial statements as presented on note 23.

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In February 2007, the FASB issued SFAS No. 159 which provides reporting entities an option to report selected financial assets, including investment securities designated as available for sale, and liabilities, including most insurance contracts, at fair value. SFAS No. 159 establishes presentation and disclosure requirements designed to facilitate comparisons between companies that choose different measurement attributes for similar types of assets and liabilities. The standard also requires additional information to aid financial statement users' understanding of a reporting entity's choice to use fair value on its earnings and also requires entities to display on the face of the balance sheet the fair value of those assets and liabilities for which the reporting entity has chosen to measure at fair value. SFAS No. 159 is effective as of the beginning of a reporting entity's first fiscal year beginning after November 15, 2007. Early adoption is permitted as of the beginning of the previous fiscal year provided the entity makes that choice in the first 120 days of that fiscal year and also elects to apply the provisions of SFAS No. 157. Because application of the standard is optional, any impacts are limited to those financial assets and liabilities to which SFAS No. 159 would be applied, which has yet to be determined, as is any decision concerning the early adoption of the standard.

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24. ADDITIONAL DISCLOSURES REQUIRED UNDER US GAAP**(a) Pension and post-retirement benefits****(i) Pension plan - Plan G1**

The Company sponsors a defined-benefit pension plan ("Plan G1"), which is operated and administered by SABESPREV. The status of this pension plan and the related actuarial assumptions presented in accordance with US GAAP are as follows:

	2006	2005		
Accumulated benefit obligation				
Vested	331,324	369,490		
Non-vested	669,684	270,764		
Total	1,001,008	640,254		
Projected benefit obligation	1,096,219	790,552		
Fair value of plan assets	(812,909)	(678,185)		
Funded position	283,310	112,367		
Unrecognized net transition obligation	-	(29,082)		
Unrecognized net gains	361,450	502,352		
Accrued pension liability (SFAS N° 87)	644,760	585,637		
Incremental Effect of Applying SFAS N° 158	(361,450)	-		
Accrued pension liability recorded in Balance Sheet (SFAS N° 158)	283,310	585,637		
	2007(1)	2006	2005	2004
Net periodic pension cost				
Service cost	33,440	17,545	9,889	11,960
Interest cost	131,848	93,270	91,886	93,991

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Expected return on assets	(96,439)	(83,065)	(70,222)	(58,478)
Amortization of transition obligation		29,082	29,082	29,082
Amortization of actuarial gain	(22,687)	(29,092)	(26,341)	(17,484)
Employee contributions	(12,925)	(15,410)	(13,752)	(13,754)
Total net periodic pension cost	33,237	12,330	20,542	45,317
<i>Weighted-average assumptions</i>				
Discount rate (nominal)		12.3%	12.3%	12.3%

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Projected long-term inflation rate	4.0%	4.0%	4.0%
Expected return on plan assets	12.1%	12.1%	12.1%
Rate of compensation increase	6.1%	6.1%	6.1%

(1) Expected NPPC for 2007 according to the Actuarial Report.

The reconciliation of changes in the projected benefit obligation and the fair value of plan assets is as follows for the years ended December 31:

	2006	2005	2004
Change in projected benefit obligation			
At beginning of year	790,552	760,015	774,126
Service cost	17,545	9,889	11,960
Interest cost	93,270	91,886	93,991
Actuarial (gain) loss	225,373	(40,978)	(93,546)
Benefits paid	(30,521)	(30,260)	(26,516)
At end of year	1,096,219	790,552	760,015
Change in fair value of plan assets			
At beginning of year	678,185	584,702	482,881
Actual return on plan assets	138,444	98,667	104,015
Employer contributions	11,391	11,324	10,298
Employee contributions	15,410	13,752	14,024
Gross benefits paid	(30,521)	(30,260)	(26,516)
At end of year	812,909	678,185	584,702
Funded status	283,310	112,367	175,313
Unrecognized actuarial gain	361,450	502,352	459,269
Unrecognized net transition obligation	-	(29,082)	(58,164)
Net amounts recognized in financial statements (SFAS N° 87)	644,760	585,637	576,418
Incremental Effect of Applying SFAS N° 158	(361,450)	-	-
Net amounts recognized in financial			

statements (SFAS N° 158)	283,310	585,637	576,418
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The date used to determine pension benefits was December 31, 2006.

The amortization of the unrecognized liability at transition is over 16 years commencing on January 1, 1990.

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The expected long-term rate of return on plan assets was determined based on the weighted average estimated return of the plan assets, which includes equity securities, real state, loans and fixed income, based on information obtained from SABESPREV. This projected long-term rate includes the projected long-term inflation rate and takes into consideration such factors as projected future interest yield curves and economic projections available in the market.

The plan's investment policies and strategies are aimed to reduce investment risk through diversification, considering such factors as the liquidity needs and funded status of plan liabilities, types and availability of financial instruments in the local market, general economic conditions and forecasts as well as requirements under local pension plan law. The plan's asset allocation and external asset management strategies are determined with the support of reports and analyses prepared by SABESPREV and independent financial consultants. Under its current investment strategy, pension assets of the Company are allocated with a goal to achieve the following distribution:

Assets category	%
Equity securities	17.1
Real estate	6.0
Loans	3.6
Fixed income	73.3
Total	100.00

Restrictions with respect to asset portfolio investments, in the case of federal government securities for internal management, are as follows:

- papers securitized by the National Treasury will not be permitted.
- exposure to fluctuations in exchange rates will not be permitted, i.e., if there are any exchange bills in the portfolio, swaps must be used to hedge existing exposure.

Restrictions with respect to asset portfolio investments, in the case of variable-income securities for external management, are as follows

- day-trade operations will not be permitted.
- sale of uncovered options is prohibited.
- swap operations without guarantee are prohibited.
- leverage will not be permitted, i.e., operations with derivatives representing leverage of asset or selling short are prohibited; such operations cannot result in losses higher than invested amounts.

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The weighted average actual asset allocations of Plan G1 at December 31 by asset category, are as follows for the years ended December 31:

Asset Category	%	
	2006	2005
Equity securities	13	15
Real estate	6	6
Loan	3	-
Fixed income	78	79
Total	100	100

Expected future benefit payments, which reflect expected future service as appropriate, under Plan G1 are as follows:

G1 Plan	
2007	52,044
2008	57,825
2009	64,273
2010	70,711
2011	77,509
Years 2012-2021	1,032,647
Total	1,355,009

The expected Company's contributions for 2007 amounts to R\$ 12,624.

(ii) Pension plan - Plan G0

The Company is also co-obligor to a supplemental defined benefit pension plan ("Plan G0").

The status of the supplemental pension benefit plan and the related actuarial assumptions used in accordance with US GAAP are as follows:

	2006	2005
Accumulated benefit obligation		

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Vested	1,195,637	1,006,397
Non-vested	1,299	83,681
Total	1,196,936	1,090,078
Projected benefit obligation	1,244,067	1,096,517
Funded position	1,244,067	1,096,517
Unrecognized actuarial gain	(87,575)	33,994
Accrued pension liability (SFAS N° 87)	1,156,492	1,130,511
Incremental Effect of Applying SFAS N° 158	87,575	-

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			2006	2005
Accrued pension liability recorded in balance sheet (SFAS N° 158)			1.244,067	1,130,511
	2007(1)	2006	2005	2004
Net periodic pension cost				
Service cost	24	397	1,858	2,531
Interest cost	146,167	126,262	121,685	117,547
Amortization of transition obligation			-	-
Total net periodic pension cost	146,191	126,659	123,543	120,078
Weighted-average assumptions				
Discount rate (nominal)		12.3%	12.3%	12.3%
Projected long-term inflation rate		4.0%	4.0%	4.0%
Rate of compensation increase		6.1%	6.1%	6.1%

(1) Expected NPPC for 2007 according to the Actuarial Report.

The reconciliation of changes in the projected benefit obligation is as follows:

	Years Ended December 31,		
	2006	2005	2004
Change in projected benefit obligation			
At beginning of year	1,096,517	1,034,285	997,534
Service cost	397	1,858	2,531
Interest cost	126,262	121,685	117,547
Actuarial (gain) loss	121,568	34,975	(397)
Benefits paid	(100,677)	(96,286)	(82,930)
At end of year	1,244,067	1,096,517	1,034,285
Funded status	1,244,067	1,096,517	1,034,285
Unrecognized actuarial gain	(87,575)	33,994	68,968
Net amounts recognized in financial			

statements (SFAS N° 87)	1,156,492	1,130,511	1,103,253
Incremental Effect of Applying SFAS N° 158	87,575	-	-
Net amounts recognized in financial statements (SFAS N° 158)	1,244,067	1,130,511	1,103,253

The date used to determine pension benefits was December 31, 2006.

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The amortization of the unrecognized liability at transition was over 15 years commencing on January 1, 1988.

Expected future benefit payments, which reflect expected future service as appropriate, under Plan G0 are as follows:

G0 Plan	
2007	110,059
2008	110,029
2009	109,802
2010	109,448
2011	109,204
Years 2012-2021	1,028,661
Total	1,577,203

(iii) Effect of initial recognition of the provisions of SFAS 158:

	Before Application of SFAS 158	Adjustment Unfunded Pension Plans	After Application of SFAS 158
Total assets	18,513,013	-	18,513,013
Accred Pension Obligation ST Plan G0	-	110,059	110,059
Accred Pension Obligation LT Plan G0	1,156,492	(22,484)	1,134,008
Plan G1	644,760	(361,450)	283,310
Deferred income tax - LT	1,037,899	122,893	1,160,792
Total liabilities	9,140,514	(150,982)	8,989,532
Accumulated other comprehensive income net of taxes	-	150,982	150,982
Total stockholders equity	7,147,182	150,982	7,298,164

(b) Other information

(i) Concentration of labor in unions

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Approximately 70% of all the Company's employees are members of unions. The four main unions that represent the Company's employees are the *Sindicato dos Trabalhadores em Água, Esgoto e Meio Ambiente de São Paulo* - SINTAEMA, *Sindicato dos Trabalhadores da Região Urbana de Santos, São Vicente, Baixada Santista, Litoral Sul e Vale Ribeira* - SINTIUS, the *Sindicato dos Engenheiros do Estado de São Paulo* - SEESP and the *Sindicato dos Advogados de São Paulo* - SASP. Every year the Company negotiates collective bargaining agreements, which establish the level of compensation and other benefits of the employees.

(ii) Law 11.445/07

On January 5, 2007, Law No. 11,445 was enacted to regulate the basic sanitation industry in Brazil. This law is in its initial stage of implementation and we cannot anticipate the effects that it will have on our operations and business. There are several uncertainties related to the new legislation, mainly with respect to the creation of the regulatory authority for the basic sanitation industry and the tariff adjustment formula and structure that will be used for new concession contracts that we enter into under the new law, which could have a material adverse effect on us.

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25. SUPPLEMENTAL INFORMATION**(a) Statement of Cash Flow**

The statement of cash flows reflects the Company's operating, investing and financing activities derived from accounting records prepared in accordance with Brazilian Corporate Law and has been presented in accordance with International Accounting Standards (IAS) No. 7 - Cash Flow Statements.

	Year ended December 31,		
	2006	2005	2004
Cash flow from operating activities:			
Net income for the year	778,905	865,647	513,028
Adjustments to reconcile net income:			
Deferred taxes and contributions	(8,473)	(32,470)	340
Provisions for contingencies	144,480	143,586	91,183
Reversal of provision for losses	(8,819)		
Other provisions	7,504		
Pension obligation	60,070	68,665	89,906
Write-off of property, plant and equipment	47,807	19,051	34,440
Write-off of deferred assets	5,195	6,700	
Write-off of investments	20	4,360	
Gain in the sale of fixed assets	(1,294)		
Depreciation	614,051	564,392	570,353
Amortization	28,120	31,589	28,558
Interests calculated on loans and financing payable	619,909	677,921	693,684
Interests, Monetary and foreign exchange variation	(8,380)	(226,573)	(101,718)
Bad debt expense	411,918	255,292	241,577
 Changes in Working Capital:			
Customers accounts receivable	(458,824)	(359,894)	(413,886)
Inventories	(12,851)	(6,466)	(7,296)
Transactions with related parties	(151,343)	(250,530)	(271,604)
Other assets	(66,412)	(15,288)	(20,639)
 Change in Liabilities:			
Suppliers	50,176	8,950	4,613
Payroll and related charges	60,416	10,061	(28,066)
Taxes and contributions Payable	(43,899)	(50,064)	6,639

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Contingencies	(79,801)	(13,921)	(4,416)
Other obligations	32,349	36,567	14,399
Cash flow from operating activities	2,020,824	1,737,575	1,441,095
Cash flow from investment Activities:			
Purchase of property, plant and equipment	(842,454)	(638,372)	(649,402)
Increase in intangibles	(12,630)	(4,748)	(25,824)
Sale of property, plant and equipment	7,837	-	176
Increase in deferred asset	(2,789)	(106)	(444)
Net cash from in investment activities	(850,036)	(643,226)	(675,494)
Cash flow from financing activities			
Loans and Financing			
Funds raised	706,774	1,153,479	910,722
Repayments	(1,660,482)	(1,991,370)	(1,719,283)

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	Year ended December 31,		
	2006	2005	2004
Payment of interest on shareholders' equity	(169,047)	(81,842)	(132,496)
Net cash used in financing activities	(1,122,755)	(919,733)	(941,057)
Increase in cash and cash equivalents	48,033	174,616	(175,456)
Cash and cash equivalents at the beginning of the year	280,173	105,557	281,013
Cash and cash equivalents at the end of the year	328,206	280,173	105,557
Supplementary cash flow information:			
Interests and fees paid on loans and financings	637,989	701,641	701,261
Income tax and social contribution paid	404,272	359,826	129,973
Non - cash transactions			
Property, plant and equipment received as donations	27,870	13,529	14,552

26. SEGMENT INFORMATION

The Company has two identifiable reportable segments: (i) water supply systems; and (ii) sewage collection systems. The chief operating decision maker uses these two segments to analyse the Company and uses income from operations before financial expenses, net as a measure of segment profit or loss.

Total assets by segment is not readily available, and therefore not regularly provided to, nor reviewed by the Company's chief operating decision maker. However, total property, plant and equipment by segment is readily available and reviewed regularly by the Company's chief operating decision maker to make decisions about resource allocations and to measure performance. As such, management believes that total property, plant and equipment is a relevant measure for its operating segments and is disclosed by segment in Note 8.

Year Ended December 31, 2006

Water system	Sewage system	Consolidated
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Gross revenue from sales and services	3,093,122	2,530,796	5,623,918
Gross sales revenue wholesale	265,298	1,870	267,168
Other sales and services	60,738	32,188	92,926
	3,419,158	2,564,854	5,984,012
Taxes on sales and services	(241,885)	(214,794)	(456,679)

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Net revenue from sales and services	3,177,273	2,350,060	5,527,333
Cost of sales and services and operating expenses	(2,460,178)	(1,263,178)	(3,723,356)
Income from operations before financial expenses, net	717,095	1,086,882	1,803,977

Year Ended December 31, 2006

	Water system	Sewage System	Common assets and concession assets acquired	Consolidated
Depreciation and amortization charges				
BR CL	(361,675)	(280,496)	-	(642,171)
US GAAP	(411,959)	(319,493)	-	(731,452)
Additions to property, plant and equipment				
BR CL	349,708	430,305	24,934	804,947
US GAAP	349,708	453,949	24,934	828,591

Year Ended December 31, 2005

	Water system	Sewage system	Consolidated
Gross revenue from sales and services	2,771,633	2,256,857	5,028,490
Gross sales revenue wholesale	241,209	-	241,209
Other sales and services	57,034	29,593	86,627
Taxes on sales and services	3,069,876 (213,394)	2,286,450 (189,569)	5,356,326 (402,963)

Net revenue from sales and services	2,856,482	2,096,881	4,953,363
Cost of sales and services and operating expenses	(2,205,146)	(1,058,644)	(3,263,790)

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Income from operations before financial expenses, net	651,336	1,038,237	1,689,573
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Year Ended December 31, 2005

	Water system	Sewage System	Common assets and concession assets acquired	Consolidated
Depreciation and amortization charges				
BR CL	(336,450)	(259,531)	-	(595,981)
US GAAP	(392,449)	(302,728)	-	(695,177)
Additions to property, plant and equipment				
BR CL	301,815	345,426	30,995	678,236
US GAAP	301,815	376,560	30,995	709,370

Year Ended December 31, 2004

	Water system	Sewage system	Consolidated
Gross revenue from sales and services	2,396,159	1,939,971	4,336,130
Gross sales revenue wholesale	217,378	-	217,378
Other sales and services	60,931	28,052	88,983
	2,674,468	1,968,023	4,642,491

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Taxes on sales and services	(133,494)	(111,925)	(245,419)
Net revenue from sales and services	2,540,974	1,856,098	4,397,072
Cost of sales and services and operating expenses	(2,051,911)	(1,017,546)	(3,069,457)
Income from operations before financial expenses, net	489,063	838,552	1,327,615

Year Ended December 31, 2004

Common

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COMPANHIA DE SANEAMENTO BÁSICO DO ESTADO DE SÃO PAULO - SABESP**NOTES TO THE FINANCIAL STATEMENTS**

AS OF AND FOR THE YEARS ENDED DECEMBER 31, 2006, 2005 AND 2004

(Amounts in thousands of Brazilian reais-R\$, unless otherwise stated)

	Water system	Sewage System	assets and concession assets acquired	Consolidated
Depreciation and amortization charges				
BR CL	(333,200)	(265,711)	-	(598,911)
US GAAP	(380,346)	(303,308)	-	(683,654)
Additions to property, plant and equipment				
BR CL	207,651	336,545	56,707	600,903
US GAAP	207,651	359,437	56,707	623,795

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COMPANHIA DE SANEAMENTO BÁSICO DO ESTADO DE SÃO PAULO - SABESP

NOTES TO THE FINANCIAL STATEMENTS

AS OF AND FOR THE YEARS ENDED DECEMBER 31, 2006, 2005 AND 2004

(Amounts in thousands of Brazilian reais-R\$, unless otherwise stated)

27. SUBSEQUENT EVENT

Program Contract with the Municipality of Lins.

Federal Law nr. 11,107 of April 2006 created the Program Contract as the legal instrument to the set up of obligations related to the transfer of public services between the entities of the Federation. This new juridical model is called associated management. The cooperation agreement is the juridical instrument able to discipline the associated management of public services, according to the provisions of article 241 of the Federal Constitution.

Thus, authorized by the cooperation agreement between the municipality of Lins and the State of São Paulo, Sabesp formalized, in January 26, 2007, the program contract with this municipality, which objective is the provision of services of water supply and sanitary sewage for 30 years, being extendable for an equal period. By the agreement, it is attributable to the State of São Paulo, through the Secretary of Sanitation and Energy, to establish the targets and define the basic sanitation policy in the State of São Paulo, incorporating the specific targets expected for the Municipality. The compensation system of the services will be by means of tariff, to be set up by the Municipality and it shall be revised, when necessary, to insure the economic-financial balance of the contract.

All assets and rights pre-existing to the contract as well as those acquired during its term integrate the services of water supply and sanitary sewage. The pre-existing amounts invested by Sabesp referring to the assets reversible by force of the concession contract terminated in 2005 remain as its property and they shall be indemnified by the municipality, in case of extinction of the present contract, when the assets will be transferred to the municipality and, then, the amount of indemnification, at the time of extinction, shall be set up. The new reversible assets shall be amortized within the period of the contract and they shall be indemnified by the municipality to Sabesp, in case of the extinction of the contract before it matures.

Grouping of Shares

The Board of Directors, in its meeting on March 30, 2007, approved the proposal for submission to the Annual Shareholders Meeting, to take place on April 30, 2007, the Grouping of Shares. On June 4, 2007, the shares were grouped in the proportion of 125 (one hundred twenty five) shares to 1 (one) share. The capital stock is represented by 227,836,623 common nominative and scriptural shares, without par value, remaining unchanged Sabesp's capital stock.

Simultaneously to the grouping operation, the American Depositary Receipts (ADRs) started to be traded in the proportion of 2 (two) shares to each ADR.

28. RESTATEMENT OF PREVIOUSLY ISSUED FINANCIAL STATEMENTS

Cash and cash equivalents

Subsequent to the issuance of the financial statements for the year ended December 31, 2005, management determined that certain investments included in exclusive investment funds that were previously classified as cash equivalents

under Brazilian GAAP should not have been classified as cash equivalents under US GAAP, since the investments have original maturities of over 90 days. Cash flows from investing activities in Note 23 have been restated to correct this classification. These reclassifications had no impact on shareholders' equity or net income for the periods presented. Under US GAAP, the summary of the effects of these restatements is as follows:

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COMPANHIA DE SANEAMENTO BÁSICO DO ESTADO DE SÃO PAULO - SABESP**NOTES TO THE FINANCIAL STATEMENTS**

AS OF AND FOR THE YEARS ENDED DECEMBER 31, 2006, 2005 AND 2004

(Amounts in thousands of Brazilian reais-R\$, unless otherwise stated)

	2005		2004		2003	
	Previously reported	Restated	Previously reported	Restated	Previously reported	Restated
Cash and cash equivalents under US GAAP	280,173	124,390	105,557	49,589	281,013	116,457
Short-term investments	-	155,783	-	55,968	-	164,556
Cash from operating activities under US GAAP	1,737,575	1,637,760	1,441,095	1,549,683		
Increase/(decrease) in cash and cash equivalents under US GAAP	174,616	74,801	48,033	(66,868)		

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