PROGRESS SOFTWARE CORP /MA
Form 10-Q
July 10, 2008

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

FORM 10-Q

(Mark One)

þ **Quarterly report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**
For the Quarterly Period Ended May 31, 2008

OR

o **Transition report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**

Commission File Number: 0-19417

PROGRESS SOFTWARE CORPORATION
(Exact name of registrant as specified in its charter)

MASSACHUSETTS	**04-2746201**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

14 Oak Park
Bedford, Massachusetts 01730
(Address of principal executive offices)(Zip code)

Telephone Number: **(781) 280-4000**

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes þ No o

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

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

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes o No þ

As of June 30, 2008, there were 41,153,000 shares of the registrant s common stock, $.01 par value per share, outstanding.

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PART 1. FINANCIAL INFORMATION
Item 1. Unaudited Consolidated Financial Statements
Condensed Consolidated Balance Sheets (unaudited)

(In thousands)

	May 31, 2008	November 30, 2007
Assets		
Current assets:		
Cash and equivalents	$216,613	$ 53,879
Short-term investments	42,413	285,646
Total cash and short-term investments	259,026	339,525
Accounts receivable, net	88,041	93,998
Other current assets	24,384	17,891
Deferred income taxes	12,124	13,009
Total current assets	383,575	464,423
Property and equipment, net	63,916	64,949
Acquired intangible assets, net	55,159	59,931
Goodwill	153,289	149,057
Deferred income taxes	19,074	17,617
Investments	67,691	
Other assets	12,298	5,851
Total	$755,002	$ 761,828
Liabilities and Shareholders Equity		
Current liabilities:		
Current portion, long-term debt	$ 317	$ 305
Accounts payable	12,524	12,684
Accrued compensation and related taxes	35,502	50,092
Income taxes payable	416	3,409
Other accrued liabilities	26,490	26,493
Short-term deferred revenue	148,402	135,487
Total current liabilities	223,651	228,470
Long-term debt, less current portion	1,190	1,352
Long-term deferred revenue	10,981	11,200
Deferred income taxes	4,507	2,817

Other non-current liabilities	5,129	115
Commitments and contingencies		
Shareholders equity:		
Common stock and additional paid-in capital; authorized, 100,000 shares; issued and outstanding, 41,269 shares in 2008 and 42,380 shares in 2007	230,466	240,647
Retained earnings and accumulated other comprehensive gains of $3,731 in 2008 and $4,833 in 2007	279,078	277,227
Total shareholders equity	509,544	517,874
Total	$755,002	$ 761,828

See notes to unaudited condensed consolidated financial statements.

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Condensed Consolidated Statements of Operations (unaudited)

(In thousands, except per share data)

	Three Months Ended May 31,		Six Months Ended May 31,	
	2008	2007	2008	2007
Revenue:				
Software licenses	$ 45,015	$ 44,555	$ 90,117	$ 89,284
Maintenance and services	82,927	75,087	159,392	145,587
Total revenue	127,942	119,642	249,509	234,871
Costs of revenue:				
Cost of software licenses	2,164	1,880	4,460	3,552
Cost of maintenance and services	17,715	16,871	35,356	33,133
Amortization of acquired intangibles for purchased technology	2,817	2,493	5,490	4,984
Total costs of revenue	22,696	21,244	45,306	41,669
Gross profit	105,246	98,398	204,203	193,202
Operating expenses:				
Sales and marketing	48,158	45,745	94,000	90,390
Product development	20,530	20,389	41,223	41,184
General and administrative	14,605	19,029	28,505	34,060
Amortization of other acquired intangibles	1,349	1,946	2,723	3,926
Total operating expenses	84,642	87,109	166,451	169,560
Income from operations	20,604	11,289	37,752	23,642
Other income (expense):				
Interest income and other	2,659	2,331	5,814	4,249
Foreign currency loss	(474)	(710)	(563)	(1,538)
Total other income, net	2,185	1,621	5,251	2,711
Income before provision for income taxes	22,789	12,910	43,003	26,353
Provision for income taxes	8,318	4,519	15,696	9,224
Net income	$ 14,471	$ 8,391	$ 27,307	$ 17,129
Earnings per share:				
Basic	$ 0.35	$ 0.20	$ 0.65	$ 0.42
Diluted	$ 0.33	$ 0.19	$ 0.62	$ 0.39

Weighted average shares outstanding:				
Basic	41,483	41,178	41,861	41,123
Diluted	43,238	43,636	43,706	43,537

See notes to unaudited condensed consolidated financial statements.

Condensed Consolidated Statements of Cash Flows (unaudited)

(In thousands)

	Six Months Ended May 31, 2008	2007
Cash flows from operating activities:		
Net income	$ 27,307	$ 17,129
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization of property and equipment	5,275	4,849
Write-down for asset impairment		2,388
Amortization of capitalized software costs		87
Amortization of acquired intangible assets	8,213	8,910
Stock-based compensation	8,080	12,408
Deferred income taxes	2,256	(1,477)
Tax benefit from stock options	2,294	230
Excess tax benefit from stock options	(1,417)	
Changes in operating assets and liabilities, net of effects from acquisitions:		
Accounts receivable, net	8,625	(925)
Other current assets	(562)	(879)
Accounts payable and accrued expenses	(17,582)	(17,927)
Income taxes payable	(4,442)	1,178
Deferred revenue	8,784	13,047
Net cash provided by operating activities	46,831	39,018
Cash flows from investing activities:		
Purchases of investments available for sale	(140,806)	(108,061)
Sales and maturities of investments available for sale	312,484	80,557
Purchases of property and equipment	(3,935)	(9,622)
Acquisition, net of cash acquired	(5,728)	
Investment in IONA Technologies	(6,668)	
Increase in other non-current assets	(411)	(827)
Net cash provided by (used for) investing activities	154,936	(37,953)
Cash flows from financing activities:		
Issuance of common stock	18,024	17,359
Excess tax benefit from stock options	1,417	1,039
Payment of long-term debt	(149)	(138)
Repurchase of common stock	(62,921)	(19,529)
Net cash used for financing activities	(43,629)	(1,269)
Effect of exchange rate changes on cash	4,596	2,162
Net increase in cash and equivalents	162,734	1,958

Cash and equivalents, beginning of period	53,879	46,449
Cash and equivalents, end of period	$ 216,613	$ 48,407

See notes to unaudited condensed consolidated financial statements.

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Notes to Unaudited Condensed Consolidated Financial Statements

Note 1: Basis of Presentation

We have prepared the accompanying unaudited condensed consolidated financial statements pursuant to the rules and regulations of the Securities and Exchange Commission (SEC) regarding interim financial reporting. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the United States of America for complete financial statements and these unaudited financial statements should be read in conjunction with the audited financial statements included in our Annual Report on Form 10-K for the fiscal year ended November 30, 2007.

In our opinion, we have prepared the accompanying unaudited condensed consolidated financial statements on the same basis as the audited financial statements, and these financial statements include all adjustments, consisting only of normal recurring adjustments, necessary for a fair presentation of the results of the interim periods presented. The operating results for the interim periods presented are not necessarily indicative of the results expected for the full fiscal year.

On December 1, 2007, we adopted SFAS No. 159 The Fair Value Option for Financial Assets and Financial Liabilities (SFAS 159) and have not elected to use fair value measurement on any assets or liabilities under this statement.

New Accounting Pronouncements

In June 2006, the FASB issued Statement of Financial Accounting Standards (SFAS) No. 141R, Business Combinations (SFAS 141R). SFAS 141R establishes a framework to improve the relevance, representational faithfulness, and comparability of the information that a reporting entity provides in its financial reports about a business combination and its effects. SFAS 141R applies prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008. We will apply SFAS 141R to any acquisition after the date of adoption.

In March 2008, the FASB issued SFAS No. 161, Disclosures about Derivative Instruments and Hedging Activities (SFAS 161) as an amendment to SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities . SFAS 161 requires that objectives for using derivative instruments be disclosed in terms of underlying risk and accounting designation. SFAS 161 is effective for financial statements issued for fiscal years beginning after November 15, 2008. We are currently evaluating whether adoption of SFAS 161 will have an impact on our consolidated financial statements.

Note 2: Revenue Recognition

We recognize software license revenue upon shipment of the product or, if delivered electronically, when the customer has the right to access the software, provided that the license fee is fixed or determinable, persuasive evidence of an arrangement exists and collection is probable. We do not consider software license arrangements with payment terms greater than ninety days beyond our standard payment terms to be fixed and determinable and therefore such software license fees are recognized upon due date. We do not license our software with a right of return and generally do not license our software with conditions of acceptance. If an arrangement does contain conditions of acceptance, we defer recognition of the revenue until the acceptance criteria are met or the period of acceptance has passed. We generally recognize revenue for products distributed through application partners and distributors when sold through to the end-user.

We generally sell our software licenses with maintenance services and, in some cases, also with consulting services. For the undelivered elements, we determine vendor-specific objective evidence (VSOE) of fair value to be the price charged when the undelivered element is sold separately. We determine VSOE for maintenance sold in connection with a software license based on the amount that will be separately charged for the maintenance renewal period. We determine VSOE for consulting services by reference to the amount charged for similar engagements when a software license sale is not involved.

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We generally recognize revenue from software licenses sold together with maintenance and/or consulting services upon shipment using the residual method, provided that the above criteria have been met. If VSOE of fair value for the undelivered elements cannot be established, we defer all revenue from the arrangement until the earlier of the point at which such sufficient VSOE does exist or all elements of the arrangement have been delivered, or if the only undelivered element is maintenance, then we recognize the entire fee ratably. If payment of the software license fees is dependent upon the performance of consulting services or the consulting services are essential to the functionality of the licensed software, then we generally recognize both the software license and consulting fees using the percentage of completion method.

We recognize maintenance revenue ratably over the term of the applicable agreement. We generally recognize revenue from services, primarily consulting and customer education, as the related services are performed.

Note 3: Earnings Per Share

We calculate basic earnings per share using the weighted average number of common shares outstanding. We compute diluted earnings per share on the basis of the weighted average number of common shares outstanding plus the effects of outstanding stock options using the treasury stock method. The following table provides the calculation of basic and diluted earnings per share on an interim basis:

(In thousands, except per share data)

	Three Months Ended May 31,		Six Months Ended May 31,	
	2008	2007	2008	2007
Net income	$14,471	$ 8,391	$27,307	$17,129
Weighted average shares outstanding	41,483	41,178	41,861	41,123
Dilutive impact from outstanding stock Options	1,755	2,458	1,845	2,414
Diluted weighted average shares outstanding	43,238	43,636	43,706	43,537
Earnings per share:				
Basic	$ 0.35	$ 0.20	$ 0.65	$ 0.42
Diluted	$ 0.33	$ 0.19	$ 0.62	$ 0.39

Stock options to purchase approximately 2,865,000 shares and 2,156,000 shares of common stock were excluded from the calculation of diluted earnings per share in the second quarter of fiscal years 2008 and 2007, respectively, because these options were anti-dilutive. Stock options to purchase approximately 2,715,000 shares and 2,561,000 shares of common stock were excluded from the calculation of diluted earnings per share in the first six months of fiscal years 2008 and 2007, respectively, because these options were anti-dilutive.

Note 4: Stock-based Compensation

Our stock-based compensation expense reflects the fair value of stock-based awards measured at the grant date, is recognized over the relevant service period, and is adjusted each period for anticipated forfeitures. We estimate the fair value of each stock-based award on the date of grant using the Black-Scholes option valuation model. The Black-Scholes option valuation model incorporates assumptions as to stock price volatility, the expected life of options, a risk-free interest rate and dividend yield.

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The following table provides the classification of stock-based compensation as reflected in our consolidated statements of operations:

(In thousands)

	Three Months Ended May 31,		Six Months Ended May 31,	
	2008	2007	2008	2007
Cost of software licenses	$ 13	$ 44	$ 35	$ 74
Cost of maintenance and services	226	515	493	862
Sales and marketing	1,419	2,702	2,850	4,498
Product development	937	1,731	1,856	2,850
General and administrative	1,515	2,539	2,846	4,124
Total stock-based compensation expense	$4,110	$7,531	$8,080	$12,408

Note 5: Income Taxes

We provide for income taxes during interim periods based on the estimated effective tax rate for the full fiscal year. We record cumulative adjustments to the tax provision in an interim period in which a change in the estimated annual effective rate is determined. We record valuation allowances to reduce deferred tax assets to the amount that is more likely than not to be realized. We have not provided for U.S. income taxes on the undistributed earnings of non-U.S. subsidiaries, as these earnings have been permanently reinvested or would be principally offset by foreign tax credits.

On December 1, 2007, we adopted FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes, an Interpretation of FASB Statement No. 109 (FIN 48). FIN 48 contains a two-step approach to recognizing and measuring uncertain tax positions accounted for in accordance with Statement 109, Accounting for Income Taxes. The first step is to evaluate the tax position taken or expected to be taken in a tax return by determining if the weight of available evidence indicates that it is more likely than not that, on an evaluation of the technical merits, the tax position will be sustained on audit, including resolution of any related appeals or litigation processes. The second step is to measure the tax benefit as the largest amount that is more than 50% likely of being realized upon ultimate settlement.

The total amount of gross unrecognized tax benefits as of December 1, 2007 (the date of adoption of FIN 48) was $4.4 million which was reclassified to non-current liabilities. In addition, as of the date of adoption, $4.3 million of unrecognized benefits would affect our effective tax rate if realized. The adoption of FIN 48 resulted in a nominal decrease to our retained earnings. We recognize interest and penalties related to uncertain tax positions as a component of our provision for income taxes and the gross amount of interest and penalties accrued as of the date of adoption was $0.3 million.

Domestically, U.S. federal and state taxing authorities are currently examining our income tax returns for years through fiscal 2005. Many issues are at an advanced stage in the examination process, the most significant of which relates to research and development credits. With all domestic audit issues considered in the aggregate, we believe it was reasonably possible that, as of December 1, 2007, the unrecognized tax benefits related to these audits could decrease (whether by payment, release, or a combination of both) in the next 12 months by as much as $1.5 million. Our U.S. federal and, with some exceptions, our state income tax returns have been examined or are closed by statute for all years prior to fiscal 2003, and we are no longer subject to audit for those periods.

Internationally, tax authorities for certain non-U.S. jurisdictions are also examining returns affecting unrecognized tax benefits. With some exceptions, we are generally no longer subject to tax examinations in non-U.S. jurisdictions for years prior to fiscal 2001.

We believe that we have adequately provided for any reasonably foreseeable outcomes related to our tax audits and that any settlement will not have a material adverse effect on our consolidated financial position or results of operations. However, there can be no assurances as to the possible outcomes.

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Note 6: Adoption of SFAS 157 Fair Value Measurements

On December 1, 2007, we adopted SFAS No. 157 Fair Value Measurements (SFAS 157). In February 2008, the FASB issued FASB Staff Position No. FAS 157-2, Effective Date of FASB Statement No. 157 , which provides a one year deferral of the effective date of SFAS 157 for non-financial assets and non-financial liabilities, except those that are recognized or disclosed in the financial statements at fair value at least annually. Therefore, we only have adopted the provisions of SFAS 157 with respect to our financial assets and liabilities. This statement defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements. The following table details the fair value measurements within the fair value hierarchy of our financial assets:

(In thousands)

		Fair Value Measurements at the Reporting Date Using		
Description	May 31, 2008	Quoted Prices in Active Markets Using Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Available-for-sale securities	$110,104	$ 42,413		$ 67,691
Investment in IONA	6,534	6,534		
Foreign exchange derivatives	565		$ 565	
Total	$117,203	$ 48,947	$ 565	$ 67,691

Since the end of the first quarter, we have reclassified our investments related to auction rate securities (ARS) to the Level 3 category, which total $67.7 million and are classified as non-current. Previously, such investments were classified in the Level 2 category. We reclassified our ARS to the Level 3 category as some of the inputs used in the trinomial discount model (described below) included unobservable inputs. Our ARS are floating rate securities with longer-term maturities which are marketed by financial institutions with auction reset dates at primarily 28 or 35 day intervals to provide short-term liquidity. The underlying collateral of the ARS consist primarily of municipal bonds, which are insured by monoline insurance companies, with the remainder consisting of student loans, which are supported by the federal government as part of the Federal Family Education Loan Program (FFELP) and by the monoline insurance companies. Beginning in February, auctions for these securities began to fail, and the interest rates for these ARS reset to the maximum rate per the applicable investment offering document. As of February 29, 2008, our ARS investments totaled $109.8 million. During the second quarter, investments totaling $38.2 million were either redeemed at par by the issuer or sold at a successful auction, reducing the par value of our ARS investments to $71.6 million. We will not be able to access these remaining funds until a future auction for these ARS is successful, we sell the securities in a secondary market which currently is not active, or they are redeemed by the issuer. As such, these remaining investments currently lack short-term liquidity and were therefore reclassified as non-current on our balance sheet.

The following table reflects the activity for our major classes of assets measured at fair value using level 3 inputs:

(In thousands)

	Available For-sale

	Securities
Balance, December 1, 2007	$
Transfers from Level 2	109,800
Redemptions and sales	(38,245)
Unrealized losses included in accumulated other comprehensive loss	(3,864)
Balance, May 31, 2008	$ 67,691

For each of our ARS, we evaluated the risks related to the structure, collateral and liquidity of the investment, and forecasted the probability of issuer default, auction failure and a successful auction at par or a redemption at par for

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each future auction period. Using a trinomial discount model, the weighted average cash flow for each period was then discounted back to present value for each security. Based on this methodology, we determined that the fair value of our ARS investments is $67.7 million, and we recorded a temporary impairment charge of $3.9 million to reduce the value of our ARS. Based on our cash and short-term investments balance of $259.0 million and expected operating cash flows, we do not anticipate the lack of liquidity associated with our ARS to adversely affect our ability to conduct business and believe we have the ability to hold the remaining securities throughout the currently estimated recovery period, therefore the impairment was only temporary in nature.

Note 7: Comprehensive Income

The components of comprehensive income include net income, foreign currency translation adjustments and unrealized gains and losses on investments. The following table provides the composition of comprehensive income on an interim basis:

(In thousands)

	Three Months Ended May 31,		Six Months Ended May 31,	
	2008	2007	2008	2007
Net income, as reported	$14,471	$8,391	$27,307	$17,129
Foreign currency translation adjustments, net of tax	879	1,386	1,299	1,218
Unrealized gains (losses) on investments, net of tax	(2,465)	(17)	(2,401)	(34)
Total comprehensive income	$12,885	$9,760	$26,205	$18,313

Note 8: Common Stock Repurchases

In September 2007, the Board of Directors authorized, for the period from October 1, 2007 through September 30, 2008, the purchase of up to 10,000,000 shares of our common stock, at such times that management deems such purchases to be an effective use of cash. We purchased and retired approximately 2,088,000 shares of our common stock for $62.9 million in the first six months of fiscal 2008 as compared to approximately 705,000 shares of our common stock for $19.5 million in the first six months of fiscal 2007.

Note 9: Goodwill

Goodwill is the amount by which the cost of acquired net assets in a business acquisition exceeded the fair value of net identifiable assets on the date of purchase. Goodwill in certain jurisdictions changes each period due to changes in foreign currency exchange rates. During the first quarter of fiscal 2008, we completed our annual testing for impairment of goodwill and, based on those tests, concluded that no impairment of goodwill existed as of December 15, 2007. For purposes of the annual impairment test, we assigned goodwill of $30.3 million to the OpenEdge and SOA operating segment, $88.2 million to the DataDirect Technologies operating segment, excluding a preliminary allocation of $4.2 million of goodwill related to the Xcalia acquisition which occurred in February 2008, and $30.6 million to the other operating segment. See Note 10 for a description of each operating segment.

Note 10: Segment Information

At the beginning of fiscal 2008, we reorganized our business into five operating segments. The reorganization resulted in the separation of the DataXtend Division as its own separate operating segment from the Enterprise Infrastructure Division and the combination of the remainder of the Enterprise Infrastructure Division with the OpenEdge Division, which created the OpenEdge and SOA Group. Our principal operating segment conducts business as the OpenEdge and SOA Group. The OpenEdge and SOA Group provides the Progress® OpenEdge platform and the Sonic and Actional product sets, interoperable, best-in-class service infrastructure products used to build, deploy and manage a service-oriented architecture. Another significant operating segment, DataDirect Technologies, provides standards-based data connectivity software. Our other three operating segments include the DataXtend Division, the Apama Division and the EasyAsk Division.

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Segment information is presented in accordance with SFAS No. 131, Disclosures About Segments of an Enterprise and Related Information. This standard is based on a management approach, which requires segmentation based upon our internal organization and disclosure of revenue and operating income based upon internal accounting methods. Our chief decision maker (CDM) is our Chief Executive Officer.

For fiscal 2008, we have two operating segments which met the requirements for separate disclosure: OpenEdge and SOA Group and DataDirect Technologies. The other three operating segments are below the threshold for separate disclosure and are included in the Other segment. We do not manage our assets, capital expenditures, total other income or provision for income taxes by segment. We managed such items on a company basis.

The following table provides revenue and income from operations from our reportable segments on an interim basis:

(In thousands)	Three months ended, May 31, 2008	Six months ended, May 31, 2008
Revenue:		
OpenEdge and SOA segment	$ 102,654	$ 201,866
DataDirect Technologies segment	17,512	34,610
Other segment	9,363	16,054
Reconciling items	(1,587)	(3,021)
Total	$ 127,942	$ 249,509
Income (loss) from operations:		
OpenEdge and SOA segment	$ 31,052	$ 60,213
DataDirect Technologies segment	241	2,569
Other segment	(1,517)	(5,054)
Reconciling items	(9,172)	(19,976)
Total	$ 20,604	$ 37,752

We did not include prior year comparisons as it is not practical to restate the fiscal 2007 data into the fiscal 2008 structure or the fiscal 2008 data into the fiscal 2007 structure.

The reconciling items within revenue primarily represent intersegment sales, which are accounted for as if sold under an equivalent arms-length basis arrangement. Amounts included under reconciling items within income from operations represent amortization of acquired intangibles, stock-based compensation and certain unallocated administrative expenses.

Total revenue by significant product line, regardless of which segment generated the revenue, is as follows:

(In thousands)	Three Months Ended May 31,		Six Months Ended May 31,	
	2008	2007	2008	2007
DataDirect	$17,512	$16,892	$34,610	$33,197
Enterprise Infrastructure	23,316	20,894	44,796	38,016
Prog				