EPICOR SOFTWARE CORP
Form 10-Q
August 06, 2010
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

x **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the quarterly period ended June 30, 2010

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 No. 000-20740

EPICOR SOFTWARE CORPORATION

(Exact name of registrant as specified in its charter)

Delaware	**33-0277592**
(State or other jurisdiction of incorporation or organization)	**(IRS Employer Identification No.)**

18200 Von Karman Avenue

Suite 1000

Irvine, California 92612

(Address of principal executive offices, zip code)

Registrant s telephone number, including area code: (949) 585-4000

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 x No ¨

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes ¨ No ¨

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

Large accelerated filer	¨	Accelerated filer	x
Non-accelerated filer	¨	Smaller reporting company	¨

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

As of August 1, 2010, there were 63,306,979 shares of common stock outstanding.

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Part I

FINANCIAL INFORMATION

Item 1 Financial Statements:

EPICOR SOFTWARE CORPORATION

CONDENSED CONSOLIDATED BALANCE SHEETS

(in thousands)

	June 30, 2010 (*Unaudited*)	December 31, 2009
ASSETS		
Current assets:		
Cash and cash equivalents	$ 109,373	$ 106,861
Accounts receivable, net of allowance for doubtful accounts	85,357	90,011
Deferred income taxes	24,942	11,572
Inventory, net	3,033	1,819
Prepaid expenses and other current assets	18,161	13,976
Total current assets	240,866	224,239
Property and equipment, net	26,878	28,511
Deferred income taxes	21,425	21,867
Intangible assets, net	69,690	84,107
Goodwill	367,826	368,336
Other assets	9,974	10,990
Total assets	$ 736,659	$ 738,050
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 16,504	$ 13,966
Accrued compensation and benefits	15,261	21,790
Other accrued expenses	24,438	24,964
Current portion of long-term debt	214	202
Current portion of accrued restructuring costs	1,631	1,694
Current portion of deferred revenue	99,079	96,040
Total current liabilities	157,127	158,656
Long-term debt, less current portion	254,607	255,535
Accrued restructuring costs	5,035	4,423
Deferred revenue	368	392
Deferred income taxes and other income taxes	14,594	15,172
Other long-term liabilities	3,131	3,785
Total long-term liabilities	277,735	279,307

Commitments and contingencies (Note 12)

Stockholders equity:		
Common stock	66	63
Additional paid-in capital	431,346	422,460
Less: treasury stock at cost	(23,298)	(20,670)
Accumulated other comprehensive loss	(8,331)	(4,825)
Accumulated deficit	(97,986)	(96,941)
Total stockholders equity	301,797	300,087
Total liabilities and stockholders equity	$ 736,659	$ 738,050

See accompanying notes to unaudited condensed consolidated financial statements.

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EPICOR SOFTWARE CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

AND COMPREHENSIVE LOSS

(in thousands, except per share amounts)

(Unaudited)

	Three Months Ended June 30, 2010	Three Months Ended June 30, 2009	Six Months Ended June 30, 2010	Six Months Ended June 30, 2009
Revenues:				
License	$ 19,160	$ 17,533	$ 35,396	$ 30,710
Consulting	34,344	32,061	65,433	63,512
Maintenance	47,503	47,340	95,463	94,206
Hardware and other	8,158	3,513	12,154	10,711
Total revenues	109,165	100,447	208,446	199,139
Cost of revenues	51,638	44,009	96,422	90,192
Amortization of intangible assets	7,051	8,221	14,108	16,626
Total cost of revenues	58,689	52,230	110,530	106,818
Gross profit	50,476	48,217	97,916	92,321
Operating expenses:				
Sales and marketing	20,595	18,151	41,729	36,241
Software development	13,656	12,432	27,535	24,838
General and administrative	11,940	14,033	24,155	28,224
Restructuring charges and other	2,626	(204)	2,671	1,207
Total operating expenses	48,817	44,412	96,090	90,510
Income from operations	1,659	3,805	1,826	1,811
Interest expense	(5,003)	(4,877)	(9,960)	(10,870)
Interest and other income (expense), net	14	(65)	(1,292)	(231)
Loss before income taxes	(3,330)	(1,137)	(9,426)	(9,290)
Income tax provision (benefit)	(2,318)	5,543	(8,382)	(982)
Net loss	$ (1,012)	$ (6,680)	$ (1,044)	$ (8,308)
Comprehensive loss:				
Net loss	$ (1,012)	$ (6,680)	$ (1,044)	$ (8,308)
Unrealized foreign currency translation gain (loss)	(2,194)	2,154	(3,506)	(508)
Net unrealized gain (loss) on derivative financial instruments, net of tax		94		(15)
Net unrealized loss on defined benefit pension plan liabilities, net of tax		(35)		(48)
Comprehensive loss	$ (3,206)	$ (4,467)	$ (4,550)	$ (8,879)
Net loss per share:				
Basic	$ (0.02)	$ (0.11)	$ (0.02)	$ (0.14)

Diluted	$ (0.02)	$ (0.11)	$ (0.02)	$ (0.14)
Weighted average common shares outstanding:				
Basic	58,990	59,486	58,813	59,237
Diluted	58,990	59,486	58,813	59,237

See accompanying notes to unaudited condensed consolidated financial statements.

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EPICOR SOFTWARE CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands)

(Unaudited)

	Six Months Ended June 30, 2010	Six Months Ended June 30, 2009
Operating activities		
Net loss	$ (1,044)	$ (8,308)
Adjustments to reconcile net loss to net cash provided by operating activities:		
Depreciation and amortization	17,794	20,745
Stock-based compensation expense	7,740	4,062
Provision for doubtful accounts	546	2,102
Provision for excess and obsolete inventory	16	199
Amortization and write-off of debt issuance fees	848	1,861
Amortization of long-term debt discount	4,172	3,882
Change in deferred taxes	(353)	(3,293)
Restructuring charges and other	2,671	1,207
Change in fair value of derivatives	(142)	
Excess tax benefits from share-based payment arrangements	(659)	(2)
Changes in operating assets and liabilities, net of effects of acquisitions and dispositions:		
Accounts receivable	2,341	4,886
Inventory	(1,229)	1,799
Prepaid expenses and other current assets	(4,368)	(2,145)
Other assets	(19)	(353)
Income taxes payable	(10,424)	(2,066)
Accounts payable	2,838	(968)
Accrued expenses	(8,534)	(5,620)
Accrued restructuring costs	(1,763)	(3,853)
Deferred revenue	4,348	(630)
Other long-term liabilities	(555)	2,217
Net cash provided by operating activities	14,224	15,722
Investing activities		
Purchases of property and equipment	(2,207)	(2,039)
Cash paid for business combinations	(684)	(953)
Net cash used in investing activities	(2,891)	(2,992)
Financing activities		
Principal payments on long-term debt	(5,104)	(16,065)
Proceeds from exercise of stock options	240	9
Proceeds from employee stock purchase plan	271	244
Excess tax benefits from share-based payment arrangements	659	2
Purchase of treasury stock	(2,628)	(980)
Net cash used in financing activities	(6,562)	(16,790)
Effect of exchange rate changes on cash	(2,259)	332

Net increase (decrease) in cash and cash equivalents	2,512	(3,728)
Cash and cash equivalents at beginning of period	106,861	89,764
Cash and cash equivalents at end of period	$ 109,373	$ 86,036

See accompanying notes to unaudited condensed consolidated financial statements.

EPICOR SOFTWARE CORPORATION

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

JUNE 30, 2010

Note 1. Basis of Presentation

The accompanying Unaudited Condensed Consolidated Financial Statements included herein have been prepared by Epicor Software Corporation (the Company) in conformity with accounting principles generally accepted in the United States of America (GAAP) and pursuant to the rules and regulations of the Securities and Exchange Commission (the SEC) for interim financial information for reporting on Form 10-Q. Certain information and footnote disclosures normally included in financial statements prepared in accordance with GAAP have been condensed or omitted pursuant to such rules and regulations. These Unaudited Condensed Consolidated Financial Statements should be read in conjunction with the consolidated financial statements and notes thereto included in the Company s Annual Report on Form 10-K for the year ended December 31, 2009.

In the opinion of management, the Unaudited Condensed Consolidated Financial Statements contain all adjustments (consisting only of normal recurring adjustments) necessary for a fair presentation of the Company s financial position, results of operations and cash flows.

The results of operations for the three and six months ended June 30, 2010, are not necessarily indicative of the results of operations that may be reported for any other interim period or for the entire year ending December 31, 2010. The Condensed Consolidated Balance Sheet at December 31, 2009, has been derived from the audited financial statements at that date, but does not include all of the information and footnotes required by accounting principles generally accepted in the United States of America for complete financial statements, as permitted by SEC rules and regulations for interim reporting.

Inventory is comprised solely of finished goods. Accounts receivable is net of allowance for doubtful accounts of $6,794,000 and $8,557,000 at June 30, 2010 and December 31, 2009, respectively.

Note 2. Basic and Diluted Net Loss Per Share

Basic net loss per share is computed by dividing the net loss for the period by the weighted average number of common shares outstanding during the period, excluding shares of unvested restricted stock. Diluted net loss per share is computed by dividing the net loss for the period by the weighted average number of common and potential common shares outstanding during the period if their effect is dilutive.

The following table computes basic and diluted net loss per share (*in thousands, except per share amounts*):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2010	2009	2010	2009
Net loss applicable to common stockholders	$ (1,012)	$ (6,680)	$ (1,044)	$ (8,308)
Basic:				
Weighted average common shares outstanding	63,271	62,678	62,953	62,392
Weighted average common shares of unvested restricted stock	(4,281)	(3,192)	(4,140)	(3,155)
Shares used in the computation of basic and diluted net loss per share	58,990	59,486	58,813	59,237
Net loss per share applicable to common stockholders basic and diluted	$ (0.02)	$ (0.11)	$ (0.02)	$ (0.14)

Due to net losses for all periods presented, the assumed exercise of stock options, employee stock purchase plan shares and unvested restricted stock had an anti-dilutive effect and therefore these potential common shares were excluded from the computation of diluted loss per share. On May 8, 2007, the Company closed an offering of $230 million aggregate principal amount of convertible senior notes (Note 7). The notes are only dilutive when the common stock price exceeds the conversion price of approximately $18.10 per share, therefore, no shares have been

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EPICOR SOFTWARE CORPORATION

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

JUNE 30, 2010

included in the calculation of diluted net loss per share as the conversion value did not exceed the principal amount of the notes.

Note 3. Goodwill and Intangible Assets

In acquisitions accounted for using the purchase method, goodwill was recorded for the difference, if any, between the aggregate consideration paid for an acquisition and the fair value of the net assets acquired. In acquisitions accounted for using the acquisition method, goodwill is recorded as the excess, if any, of the consideration transferred plus the fair value of any non-controlling interest in the acquiree over the fair value of the identifiable net assets acquired. An annual review of goodwill and indefinite-lived intangibles is required for possible impairment. The Company performed its annual impairment review of its recorded goodwill in the fourth quarter of 2009, and determined that no impairment of goodwill existed at that time because the estimated fair value of each reporting unit exceeded its carrying amount. The Company monitors the indicators for goodwill impairment testing between annual tests. Certain adverse business conditions impacting one or more of the Company s reporting units would cause the Company to test goodwill for impairment on an interim basis. No such events occurred during the six months ended June 30, 2010.

The following table represents the balance and changes in goodwill by reporting unit as of and for the six months ended June 30, 2010 (*in thousands*):

	License	Consulting	Maintenance	Total
Balance as of December 31, 2009	$ 140,234	$ 70,767	$ 157,335	$ 368,336
Scala Africa earn out	76	65	413	554
Foreign currency translation	(271)	(411)	(382)	(1,064)
Balance as of June 30, 2010	$ 140,039	$ 70,421	$ 157,366	$ 367,826

The average amortization period for intangible assets are as follows:

	Average Amortization Periods
Acquired technology	5 years
Customer base	7 years
Trademark	5 years
Covenants not to compete	1-2 years

The following represents the change in the gross carrying amount of intangible assets recorded during the six months ended June 30, 2010 (*in thousands*):

	Foreign Currency Translation	Other	Total
Acquired technology	$ (26)	$	$ (26)
Customer base	(1,396)	130	(1,266)

Covenant not to compete	(116)		(116)
Total	$ (1,538)	$ 130	$ (1,408)

Intangible assets are amortized over the estimated economic life of the assets. As of June 30, 2010, the Company has not identified any indicators of impairment associated with intangible assets.

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EPICOR SOFTWARE CORPORATION

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

JUNE 30, 2010

The following table summarizes the components of intangible assets *(in thousands)*:

	As of June 30, 2010			As of December 31, 2009		
	Gross Carrying Amount	Accumulated Amortization	Net	Gross Carrying Amount	Accumulated Amortization	Net
Acquired technology	$ 137,677	$ 104,085	$ 33,592	$ 137,703	$ 95,400	$ 42,303
Customer base	74,901	40,876	34,025	76,167	37,076	39,091
Trademark	13,790	11,717	2,073	13,790	11,077	2,713
Covenant not to compete	2,047	2,047		2,163	2,163	
Total	$ 228,415	$ 158,725	$ 69,690	$ 229,823	$ 145,716	$ 84,107

Amortization expense of the Company s intangible assets is included in cost of revenues and for the three months ended June 30, 2010 and 2009, was $7,051,000 and $8,221,000, respectively. Amortization expense of the Company s intangible assets is included in cost of revenues and for the six months ended June 30, 2010 and 2009, was $14,108,000 and $16,626,000, respectively. Estimated amortization expense for the remainder of 2010, 2011, 2012, 2013, 2014 and thereafter, is approximately $13,662,000, $21,501,000, $20,063,000, $7,871,000, $6,016,000 and $577,000, respectively.

Note 4. Restructuring Charges and Other

During the first six months of 2010, the Company recorded restructuring charges of $2,606,000. These charges represent $1,351,000 of severance costs associated with cost reductions initiatives taken in the second quarter as well as management severance. The Company also recorded a charge of $1,255,000 for changes in estimates on subleasing arrangements for facilities located in the United Kingdom. In connection with these restructuring activities, the Company terminated 31 employees or approximately 1% of the Company s workforce during 2010 from across all functions. As of June 30, 2010, all of these terminations had been completed. During the six months ended June 30, 2010, the Company made $1,763,000 in cash payments or otherwise settled against reserves associated with its restructuring activities. The liability was further decreased by $294,000 of foreign currency translation. The facilities obligations are expected to be paid through 2016 and the Company believes these obligations will be funded from existing cash reserves and cash generated from continuing operations.

During the first six months of 2009, the Company recorded restructuring charges of $1,207,000. These charges represent $1,758,000 of severance related costs associated with the cost reduction initiatives taken in the second quarter, management severance and reductions primarily from the elimination of redundancies in the Company s retail business resulting from the NSB acquisition. The Company also recorded $693,000 of facilities credits related primarily to changes in estimates on subleasing facilities located in the United Kingdom. The Company also recorded $142,000 in asset impairments related to leasehold improvements and facilities redundancies in the Company s retail business resulting from the NSB acquisition. In connection with these restructuring activities, the Company terminated 43 employees or approximately 2% of the Company s workforce during 2009 primarily from professional services and sales functions. As of June 30, 2009, all of these terminations had been completed. During the six months ended June 30, 2009, the Company made $3,875,000 in cash and share-based payments against reserves associated with its restructuring activities. The liability was further increased by $861,000 of foreign currency translation.

Note 5. Stock-Based Compensation

The Company has in effect stock incentive plans under which restricted stock and stock options have been granted to employees and non-employee members of the Board of Directors. The Company also has an employee stock purchase plan for eligible employees. The Company recognizes share-based payments to employees, including grants of employee restricted stock and stock options, in the financial statements based upon their respective grant date fair values.

The following table sets forth the total stock-based compensation expense resulting from restricted stock awards and stock options included in the Company s Condensed Consolidated Statements of Operations and Comprehensive Loss (*in thousands*):

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EPICOR SOFTWARE CORPORATION

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

JUNE 30, 2010

	Three Months Ended June 30,		Six Months Ended June 30,	
	2010	2009	2010	2009
Cost of revenues	$ 538	$ 345	$ 1,088	$ 657
Sales and marketing	737	415	1,565	1,022
Software development	614	171	1,242	348
General and administrative	1,572	713	3,845	2,035
Total stock-based compensation expense	$ 3,461	$ 1,644	$ 7,740	$ 4,062

In January 2010, the Company s Board of Directors approved extending the Performance Based Restricted Stock Plan (PBRSP) to 2011. All existing participants in the PBRSP were granted the same number of shares for the 2010 and 2011 plan years as they had been granted in the 2009 plan year. During the six months ended June 30, 2010, the Company granted 1,553,000 shares of performance-based restricted stock to employees for extension of the PBRSP to 2011, and for annual promotions and new hires for the 2010 and 2011 performance plan years under the terms of the PBRSP. In January 2010, the Company s Board of Directors also approved modifying and replacing the Company s prior cash-based management bonus plan with a performance-based restricted stock Management Incentive Program (MIP) for 2010. In creating the equity based MIP, an additional 1,328,000 performance-based restricted shares were granted for the 2010 year. All performance-based restricted shares are subject to a vesting schedule and are subject to the terms of the Company s PBRSP and MIP. The recipients will vest in the restricted stock, or a portion thereof, in two equal, annual installments depending upon achievement of targets with respect to the Company s annual revenue and adjusted earnings before interest, taxes, depreciation and amortization (EBITDA) for 2010 and additionally, for PBRSP participants, for 2011. Unvested restricted stock is held in escrow, and the Company s reacquisition right will not lapse until the shares are fully vested. Upon an employee s termination of service with the Company, shares that have not vested will be forfeited and automatically transferred to and reacquired by the Company. In addition, restricted shares that do not vest as a result of the Company s non-achievement with respect to annual revenue and adjusted EBITDA performance conditions for either performance year will be forfeited and automatically transferred to and reacquired by the Company.

The performance conditions for each year are independent of the performance conditions for any other years. Accordingly, the related compensation expense will be recognized separately in each year related only to the shares potentially earned in each year, based on their grant date fair values, assuming that it is considered to be probable that the shares will be earned each year. In addition, the compensation expense for each year is estimated at each reporting period and a cumulative pro rata amount is accrued on a quarterly basis. Quarterly compensation expense may include a cumulative adjustment resulting from changes in the estimated number of shares expected to be earned during that plan year.

On February 12, 2010, the Company s reacquisition right lapsed on 563,000 shares related to the performance-based restricted stock plan for the 2009 performance year. These shares were included in restricted stock at December 31, 2009. The lapse occurred following the Company s determination of its 2009 performance year performance conditions achievement. The compensation expense related to these shares was included in the Consolidated Statements of Operations for the year ended December 31, 2009.

The Company withholds, at the employee s election, a portion of the vested shares as consideration for the Company s payment of applicable employee income taxes. As of June 30, 2010, these repurchased shares are held in treasury and are available for future reissuance. In conjunction with the periodic vesting of the restricted stock and the annual vesting of performance-based restricted stock, during the three and six months ended June 30, 2010, the Company acquired 89,000 and 300,000 shares of common stock at a value of $869,000 and $2,628,000, respectively.

At June 30, 2010, the Company had approximately $12,243,000 of total unrecognized compensation expense related to performance-based restricted stock. This cost is expected to be recognized over a weighted-average period of approximately two years. At June 30, 2010, the Company had approximately $2,781,000 of total unrecognized compensation expense related to other restricted stock grants. This cost is expected to be recognized over a weighted-average period of approximately two years. The compensation cost related to the performance-based restricted stock depends on the estimated number of shares that will vest, based on the probable outcome of the performance conditions. Therefore, the recognized compensation could vary significantly, depending on the outcome of those conditions. The Company is required at each reporting date to assess whether achievement of any

EPICOR SOFTWARE CORPORATION

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

JUNE 30, 2010

performance condition is probable. Based on the Company s current assessment, the Company has recorded stock compensation expense related to performance-based restricted stock of $2,820,000 and $5,575,000 for the three and six months ended June 30, 2010, respectively.

The fair value of restricted stock that vested during the three months ended June 30, 2010 and 2009, was $2,090,000 and $2,448,000, respectively. The fair value of restricted stock that vested during the six months ended June 30, 2010 and 2009, was $3,022,000 and $3,989,000, respectively.

The tax benefit recognized in the Condensed Consolidated Statement of Operations and Comprehensive Loss related to stock-based compensation for the three months ended June 30, 2010 and 2009 was $1,038,000 and $404,000, respectively. The tax benefit recognized in the Condensed Consolidated Statement of Operations and Comprehensive Loss related to stock-based compensation for the six months ended June 30, 2010 and 2009 was $2,410,000 and $1,216,000, respectively. No share-based compensation was capitalized for the three or six months ended June 30, 2010 or 2009.

The Company granted zero stock options during the three months ended June 30, 2010 and 2009. The Company granted zero and 15,000 stock options during the six months ended June 30, 2010 and 2009, respectively. Stock options are granted with an exercise price equal to the market value on the date of grant, generally vest over four years and expire ten years from the date of grant. The weighted-average grant date fair value of options granted in fiscal 2009 was $1.96. The Company estimates the fair value of each option grant on the date of grant using the Black-Scholes option-pricing model. The Black-Scholes option-pricing model was developed for use in estimating the value of traded options that have no vesting restrictions and are fully transferable, while the options issued by the Company are subject to both vesting and restrictions on transfer. In addition, option-pricing models require input of highly subjective assumptions including expected stock price volatility. The Company uses historical volatility data for expected volatility and estimates the expected life of its stock options based on the historical life of the Company s options. The grant date fair value of options granted during the six months ended June 30, 2009 was estimated using the following weighted-average assumptions:

	Six Months Ended June 30, 2009
Expected life (years)	4.0
Risk-free interest rate	1.3%
Volatility	75.5%
Dividend rate	0.0%

There were 10,000 options exercised during the three months ended June 30, 2010 with an intrinsic value of $72,000. There were 61,000 options exercised during the six months ended June 30, 2010 with an intrinsic value of $327,000. As of June 30, 2010, there were 1,320,000 options exercisable with a weighted average remaining contractual term, weighted average exercise price and aggregate intrinsic value of 3.3 years, $7.88 and $3,437,000, respectively. As of June 30, 2010, there were 1,331,000 options outstanding with a weighted average remaining contractual term, weighted average exercise price and aggregate intrinsic value of 3.3 years, $7.85 and $3,483,000, respectively. The Company issues new shares to satisfy stock option exercises and stock purchases under the Company s share-based plans. The aggregate intrinsic value above represents the total pre-tax intrinsic value (the difference between the Company s closing stock price on the last trading day of the quarter and the exercise price) multiplied by the number of shares that would have been received by the option holders had all option holders exercised their options on June 30, 2010. This amount changes based on the market value of the Company s stock.

Note 6. Revenue Recognition

The Company recognizes revenue in accordance with accounting principles generally accepted in the United States of America, specifically, the Company recognizes revenue in accordance with software industry specific GAAP.

The Company enters into contractual arrangements with end-users of its products to sell software licenses, maintenance services and consulting services, either separately or in various combinations thereof. For each arrangement, revenues are recognized when persuasive evidence of an arrangement exists, the fees to be paid by the customer are fixed or determinable, collection of the fees is probable, delivery of the product has occurred, vendor-specific objective evidence (VSOE) of the fair value of any undelivered elements exists and no other significant obligations on the part of the Company remain.

EPICOR SOFTWARE CORPORATION

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

JUNE 30, 2010

For multiple-element software arrangements, the Company accounts for the software license component using the residual method. The residual method generally requires recognition of software license revenue in a multiple-element arrangement once all software products have been delivered and accepted by the customer and the only undelivered elements are maintenance services and/or consulting services. The fair value of the maintenance services is determined based on VSOE of fair value and is deferred and recorded ratably over the maintenance service period. Fair value for any related consulting services is determined by VSOE of fair value and generally recognized as the services are performed. After any required fair value allocations to the undelivered maintenance and/or consulting services elements, the residual contractual consideration is allocated to the license element associated with the software products sold as part of the transaction. The Company s maintenance services VSOE of fair value is determined by reference to the price the Company s customers are required to pay for the services when sold-separately (i.e. the maintenance service fees paid by the Company s customers upon renewal). VSOE of fair value for consulting services is determined by reference to the price the Company s customers are required to pay for such services when sold-separately, or when sold independent of any of the Company s other product or service offerings.

In certain instances, the Company enters into arrangements that include two or more non-software products or services such as hardware and related services. Such arrangements are divided into separate units of accounting provided that the delivered item has stand-alone value and there is objective and reliable evidence of the fair value of the undelivered items. The total arrangement fee is allocated to the undelivered elements based on their fair values and to the initial delivered elements using the residual method. Revenue is recognized separately, and in accordance with the Company s revenue recognition policy, for each element. Sales taxes collected from customers are recorded on a net basis.

License Revenues: Amounts allocated to software license revenues sold directly by the Company are recognized at the time of shipment of the software when fair value for all undelivered elements exists and all the other revenue recognition criteria discussed above have been met.

Revenues on sales made to the Company s resellers are recognized upon shipment of the Company s software to the reseller when the reseller has an identified end-user and all other revenue recognition criteria noted above are met. The Company does not offer a right of return on its products.

Consulting Service Revenues: Consulting service revenues are comprised of consulting and implementation services and, to a limited extent, other services such as training, software hosting, applications management and software as a service (SaaS). Consulting services are sold on a fixed fee and time-and-materials basis and can include services ranging from software installation to data conversion and building non-complex interfaces to allow the software to operate in integrated environments. Consulting engagements can last anywhere from one day to several months and are based strictly on the customer s requirements and complexities and are independent of the functionality of the Company s software. The Company s software, as delivered, can generally be used by the customer for the customer s purpose upon installation. Further, implementation and integration services provided are generally not essential to the functionality of the software, as delivered, and do not result in any material changes to the underlying software code. Services are generally separable from the other elements under the same arrangement since the performance of the services are not essential to the functionality of the other elements of the transaction, the services are described in the contract such that the total price of the arrangement would be expected to vary as the result of the inclusion or exclusion of the services, and VSOE of fair value exists for the services based on sold-separately data. For services performed on a time-and-materials basis, revenue is recognized when the services are performed and billed. On occasion, the Company enters into fixed fee arrangements or arrangements in which customer payments are tied to achievement of specific milestones. In fixed fee arrangements, revenue is recognized as services are performed as measured by hours incurred to date, as compared to total estimated hours to be incurred to complete the work. In milestone achievement arrangements, the Company recognizes revenue as the respective milestones are achieved. If, in the services element of the arrangement the Company performs significant production, modification or customization of its software, the Company accounts for the entire arrangement, inclusive of the software license revenue, using contract accounting as the software and services do not meet the criteria for separation. In such instances, the software license revenue is recognized as the services are performed utilizing the same methodology applied to fixed fee arrangements.

Hosting, outsourcing and applications management revenues consist primarily of recurring fees for remote management, monitoring, data processing, updating or administrative support of applications software, servers, operating systems and other automation tools. SaaS revenues are comprised of recurring fees for licensing access to and the use of the Company s application software as a service, on a subscription or on-demand basis over a

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NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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contractual term. Related recurring fees are recognized as the services are provided. Related one time set up fees are recognized on a straight-line basis over the longer of the contractual term or the expected life of the relationship.

The Company has recorded unbilled consulting revenues totaling $2,820,000 and $2,602,000 at June 30, 2010 and December 31, 2009, respectively. These unbilled revenues are comprised primarily of consulting services performed on a time and materials basis during the last few business days of the quarter but not billed until the following month, as well as accruals recorded for services provided under certain engagements for which the associated payment has yet to be billed in accordance with the contractual payment terms. Unbilled consulting revenues are recorded in accounts receivable in the accompanying Condensed Consolidated Balance Sheets.

Maintenance and Support Service Revenues: Maintenance and support service revenues consist primarily of fees for providing unspecified software upgrades on a when-and-if-available basis and technical support over a specified term, which is typically twelve months. Maintenance revenues are typically paid in advance and are recognized on a straight-line basis over the term of the contract.

Hardware Revenues: In some cases, the Company resells third party hardware systems and related peripherals as part of an end-to-end solution requested by its customers. Hardware revenue is recognized when persuasive evidence of an arrangement exists, delivery has occurred, the fee is fixed or determinable and collection is considered probable. The Company considers delivery to occur when the product is shipped and title and risk of loss have passed to the customer.

Software License Indemnification: The Company s standard software license agreements contain an infringement indemnity clause under which the Company agrees to defend, indemnify and hold harmless our customers and business partners against liability and damages arising from third party claims that the Company s products violate or infringe the intellectual property rights of others. These clauses constitute a form of guarantee that is subject to disclosure requirements, but not to initial recognition or measurement provisions. The Company has never lost a third party infringement claim, and, to date, the Company s costs to defend such claims and/or lawsuits have been insignificant. Although it is possible that in the future third parties may claim that the Company s current or future software solutions infringe upon their intellectual property, a maximum obligation arising out of these types of agreements is not explicitly stated and, therefore, the overall maximum amount of these obligations cannot be reasonably estimated.

Note 7. Credit Facility and Convertible Senior Notes

Credit Facility

In December 2007, the Company entered into a syndicated credit facility (the 2007 credit facility) for up to $250 million in term loan and revolving facilities, consisting of a $100 million term loan and a $150 million revolving loan facility, after giving consideration to an accordion feature which would allow the Company to increase the initial principal loaned under the 2007 credit facility. In December 2008, the Company amended the 2007 credit facility to, among other things, reduce the commitments under the revolving loan facility from $150 million to $100 million. The Company pledged all of its assets as collateral, subject to certain exceptions.

On September 30, 2009, the Company amended the 2007 credit facility to, among other things, (i) amend the financial covenants by eliminating the total leverage and fixed charge coverage ratios, lowering the maximum senior secured leverage ratio and adding a minimum EBITDA covenant and a minimum liquidity ratio, (ii) amend the maturity date from February 19, 2013 to September 30, 2012, and (iii) increase the applicable interest rates and commitment fees payable under the facility. In connection with this amendment, the Company also paid the outstanding term loan balance by drawing funds available under the revolving facility. The Company paid amendment fees to the lenders and an arrangement fee to secure the amendment.

As of June 30, 2010, the Company had $62,500,000 outstanding on the revolving facility and unused borrowing capacity of $37,500,000 under the revolving facility. During the three months ended June 30, 2010, the Company made a voluntary principal payment of $5,000,000 against the revolving loan from discretionary funds, bringing the outstanding loan balance to $62,500,000.

At June 30, 2010, the Company was in compliance with all covenants included in the terms of the 2007 credit facility, and the weighted average interest rate applicable to the 2007 credit facility was 5.28%. The 2007 credit

EPICOR SOFTWARE CORPORATION

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facility is subject to interest rate swap agreements to convert a portion of the Company s interest rate variability to a fixed rate basis as required under the 2007 credit facility (Note 8).

The Company is not obligated to make mandatory quarterly principal payments under the 2007 credit facility, however periodic interest payments are made, not less often than quarterly. All the outstanding principal and accrued interest on the revolving loan facility is due September 30, 2012, upon expiration of the facility. Accordingly, the outstanding balance of the facility at June 30, 2010 and December 31, 2009 was classified as long-term debt.

Convertible Senior Notes

On May 8, 2007, the Company closed an offering of $230 million aggregate principal amount of 2.375% convertible senior notes due in 2027 (convertible senior notes). The convertible senior notes are unsecured and pay interest semiannually at a rate of 2.375% per annum until May 15, 2027. The convertible senior notes are convertible into cash or, at the Company s option, cash and shares of the Company s common stock, at an initial conversion rate of 55.2608 shares of common stock per $1,000 principal amount of the convertible senior notes, which is equivalent to an initial conversion price of approximately $18.10 per share. Pursuant to the terms of the convertible senior notes, the principal amount of the convertible senior notes may be settled in cash and only the amount of conversion value, as defined, in excess of the principal amount of the convertible senior notes may be settled in cash or shares. The initial conversion price represents a 30% premium over the last reported sale price of the Company s common stock prior to the offering that began on May 2, 2007, which was $13.92 per share.

The Company recorded a $61,752,000 debt discount as additional paid-in capital, as of the convertible senior notes issuance date of May 15, 2007. At June 30, 2010 and December 31, 2009, the unamortized debt discount was $37,970,000 and $42,143,000, respectively. The Company has $230,000,000 in principal due under the convertible debt, for a net carrying amount of $192,030,000 at June 30, 2010. At June 30, 2010, the fair value of the debt was $205,436,000, as determined based upon quoted market prices.

The Company is amortizing the debt discount through the date at which the Company can begin to redeem the notes, which is May 15, 2014. The effective interest rate used to measure the initial fair value of the debt was 7.35%, which was based on market conditions for nonconvertible debt at the time the debt was entered into. The Company recognized interest expense of $3,471,000 and $3,324,000 related to the convertible debt for the three months ended June 30, 2010 and 2009, respectively, of which $1,366,000 is based on the coupon rate. The Company recognized interest expense of $6,904,000 and $6,613,000 related to the convertible debt for the six months ended June 30, 2010 and 2009, respectively, of which $2,731,000 is based on the coupon rate.

Note 8. Derivative Instruments

The Company is exposed to certain risks relating to its ongoing business operations. The Company uses derivative instruments to manage interest rate risk and foreign currency risk. Interest rate swaps are entered into to manage interest rate risk associated with the Company s variable rate borrowings. Foreign currency forward contracts are entered into to manage foreign currency exchange rate risk associated with intercompany receivable and payable balances. The Company does not use derivative instruments for trading purposes.

Interest rate swaps were entered into in connection with the term loan previously outstanding under the 2007 credit facility and were initially designated and qualified as cash flow hedges, whereby the effective portion of the gain or loss on the derivative was reported as a component of other comprehensive income and reclassified into earnings in the same period during which the hedged transaction affected earnings. If the Company had experienced gains or losses on the derivatives representing either hedge ineffectiveness or hedge components excluded from the assessment of effectiveness, they would have been recognized in current earnings.

On September 30, 2009, the Company paid in full the balance outstanding on its term loan by borrowing on the revolving line of credit under the 2007 credit facility (Note 7). Both the term loan and the revolving credit facility incur a variable interest rate. Because the interest rate swaps were designated as hedging the interest rate variability on the term loan, repayment of the term loan resulted in the de-designation of this hedging relationship. Accordingly, subsequent to September 30, 2009, the interest rate swaps are no longer designated in a hedging relationship.

For the three months ended June 30, 2010, a gain for the change in the fair value of the interest rate swaps of $138,000 was recognized in interest and other income (expense), net in the accompanying Condensed

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Consolidated Statements of Operations and Comprehensive Loss. For the six months ended June 30, 2010, a gain for the change in the fair value of the interest rate swaps of $142,000 was recognized in interest and other income (expense), net in the accompanying Condensed Consolidated Statements of Operations and Comprehensive Loss.

The Company s foreign currency contracts are not designated and do not qualify as hedging instruments, and gains and losses resulting from these transactions are included in interest and other income (expense), net in the accompanying Condensed Consolidated Statements of Operations and Comprehensive Loss. As of June 30, 2010, the Company had no open foreign currency forward contracts.

Interest Rate Swaps

On April 18, 2008, March 11, 2009 and March 12, 2009, the Company entered into interest rate swap agreements to convert a portion of the Company s interest rate variability to a fixed rate basis as required under the 2007 credit facility. As of June 30, 2010 and December 31, 2009, the fair value of the interest rate swaps is included on the Company s Condensed Consolidated Balance Sheets. The differential to be paid or received on the interest rate swap agreements is accrued and recognized as an adjustment to interest expense as interest rates change. Following is a summary of the interest rate swaps (rates for expired contracts are exclusive of an interest rate margin and rates for active contracts are inclusive of the interest rate margin of 4.00% applicable at June 30, 2010 under the 2007 credit facility):

Contract Date	Notional Amount	Interest Period Covered	Rate
04/18/08	$20 million	06/30/08 03/31/09	3.170%
04/18/08	$15 million	06/30/08 09/30/09	3.195%
04/18/08	$15 million	06/30/08 09/30/09	3.150%
03/11/09	$20 million	03/31/09 03/31/11	5.690%
03/12/09	$15 million	09/30/09 03/31/11	5.890%
03/12/09	$ 5 million	09/30/09 09/30/10	6.050%

At June 30, 2010, the effective interest rate for the notional amounts covered by the swap agreements as of such date was 5.81% (inclusive of 4.00% interest rate margin applicable at March 31, 2010 under the 2007 credit facility).

The Company does not hold or issue interest rate swap agreements for trading purposes. In the event that a counter-party fails to meet the terms of the interest rate swap agreement, the Company s exposure is limited to the interest rate differential. The Company manages the credit risk of counterparties by dealing only with institutions that the Company considers financially sound. The Company considers the risk of non-performance to be remote.

Foreign Currency Contracts

The Company uses foreign currency forward contracts to manage its market risk exposure associated with foreign currency exchange rate fluctuations for certain intercompany balances denominated in currencies other than an entity s functional currency. These derivative instruments are not designated and do not qualify as hedging instruments. Accordingly, the gains or losses on these derivative instruments are recognized in interest and other income (expense), net in the accompanying Condensed Consolidated Statements of Operations and Comprehensive Loss and are designed generally to offset the gains and losses resulting from remeasurement of intercompany balances recognized in the same line item. The Company reported a net foreign currency loss of $316,000 and $418,000 for the three months ended June 30, 2010 and 2009, respectively, which is inclusive of financial instruments and non-financial assets and liabilities to which the instruments relate. The Company reported a net foreign currency loss of $1,717,000 and $742,000 for the six months ended June 30, 2010 and 2009, respectively, which is inclusive of financial instruments and non-financial assets and liabilities to which the instruments relate.

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NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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Quantitative Disclosures About Derivative Instruments

The fair value of derivative instruments is as follows (*in thousands*):

		Fair Value of Liability Derivatives as of	
	Balance Sheet Location	June 30, 2010	December 31, 2009
Derivatives not designated as hedging instruments:			
Interest rate swaps	Other accrued expenses	$ 362	$ 61
Interest rate swaps	Other long-term liabilities		443
Total		$ 362	$ 504

The effects of derivative instruments on the Condensed Consolidated Statements of Operations and Comprehensive Loss on a pre-tax basis are as follows (*in thousands*):

	Amounts of Gain (Loss) Reclassified from Accumulated OCI into Income			
	Three Months Ended June 30,		Six Months Ended June 30,	
	2010	2009	2010	2009
Derivatives in cash flow hedging relationship:				
Interest rate swaps	$	$ (212)	$	$ (426)

The following table represents the amount of derivative instruments not designated as hedges recognized in the Company s Condensed Consolidated Statements of Operations and Comprehensive Loss (*in thousands*):

		Amount of Gain or (Loss) Recognized in Income on Derivatives			
		Three Months Ended June 30,		Six Months Ended June 30,	
		2010	2009	2010	2009
Derivatives not designated as hedging instruments:	Location of gain (loss) recognized in income on derivatives:				
Interest rate swaps	Interest and other income (expense), net	$ 138	$	$ 142	$
Foreign currency contracts	Interest and other income (expense), net	621	(1,423)	347	(1,392)
Total		$ 759	$ (1,423)	$ 489	$ (1,392)

U.S. GAAP requires a three-tier hierarchy for fair value measurements, which prioritizes the inputs used in measuring fair value as follows:

Level 1 observable inputs such as quoted prices for identical instruments in active markets.

Level 2 inputs other than quoted prices in active markets that are observable either directly or indirectly through corroboration with observable market data.

Level 3 unobservable inputs in which there is little or no market data, which would require the Company to develop its own assumptions.

The Company s interest rate swap is required to be measured at fair value on a recurring basis. The fair value of the interest rate swap is determined based on inputs that are readily available in public markets or can be derived from information available in publicly quoted markets. Therefore, the Company has categorized the interest rate swap as Level 2. The following tables present the Company s financial liabilities as of June 30, 2010 and December 31, 2009, measured at fair value on a recurring basis (*in thousands*):

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NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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	Fair value measurements using		
Interest rate swap liability	**Level 1**	**Level 2**	**Level 3**
June 30, 2010	$	$ 362	$
December 31, 2009		504	

Note 9. Provision (Benefit) for Income Taxes

The provision (benefit) for income taxes consists of federal, state and foreign income taxes. The Company operates in an international environment with significant operations in various locations outside the U.S. Accordingly, the consolidated income tax rate is a composite rate reflecting earnings in the various locations and the applicable rates.

The Company makes its best estimate of the tax rate expected to be applicable for the full fiscal year. The rate so determined is used to provide for income taxes in an interim period. Absent any material or discrete adjustments, the deferred taxes accounts are adjusted only at year end.

The Company recorded an income tax provision (benefit) of $(2,318,000) and $5,543,000 for the three months ended June 30, 2010 and 2009, respectively. The effective income tax rates were (69.6)% and 487.5% for the three months ended June 30, 2010 and 2009, respectively. The Company recorded an income tax benefit of $8,382,000 and $982,000 for the six months ended June 30, 2010 and 2009, respectively. The effective income tax rates were (88.9)% and (10.6)% for the six months ended June 30, 2010 and 2009, respectively.

Principal differences between the recorded benefit for income taxes and the amount determined by applying the U.S. federal statutory rate of 35% pertain to earnings in foreign jurisdictions taxed at different rates, state taxes, permanent differences between GAAP pre-tax income and taxable income, and the recognition of uncertain tax benefits. Depending on the levels of consolidated pre-tax earnings, these differences can have a significant impact on the effective tax rate.

The Company has a valuation allowance of $13,928,000 against certain foreign deferred tax assets, and intends to maintain a valuation allowance until sufficient positive evidence exists to support its reversal. In general, any realization of these deferred tax assets will reduce the Company s effective rate in future periods. Future releases of the valuation allowance related to the Scala and NSB acquisitions will be accounted for as a reduction in income tax expense.

The Company assesses the recoverability of its deferred tax assets and the need for a valuation allowance on an ongoing basis. In making this assessment, the Company is required to consider all available positive and negative evidence to determine whether, based on such evidence, it is more likely than not that some portion, or all, of the net deferred tax assets will be realized in future periods. This analysis includes assessment by jurisdiction of forecasted and historic financial performance and taxable income, performance compared to profit and revenue targets, strength or weakness of revenue generating functions, expense forecasts, and other factors. The valuation allowance will continue to be evaluated over future quarters.

The preparation of consolidated financial statements in conformity with GAAP requires the formulation of estimates and assumptions that affect the reported amount of tax-related assets and liabilities and income tax provisions. This assessment requires significant judgment. In addition, the Company has made estimates involving current and deferred income taxes, tax attributes relating to the interpretation of various tax laws and historical bases of tax attributes associated with certain tangible and intangible assets. Failure to achieve the Company s operating income targets may change its assessment regarding the recoverability of the net deferred tax assets and such change could result in a valuation allowance being recorded against some or all of the deferred tax assets. Any increase in a valuation allowance would result in additional income tax expense, lower stockholders equity and could have a significant impact on the Company s earnings in future periods.

U.S. income taxes were not provided for on unremitted earnings from non-U.S. subsidiaries. Those unremitted earnings are considered to be indefinitely reinvested.

At June 30, 2010 and December 31, 2009, the Company had $16,791,000 and $17,503,000, respectively, of non-current gross unrecognized tax benefits, of which $12,459,000 and $12,910,000, respectively, would reduce the effective tax rate if recognized. The change in gross unrecognized tax benefits during the quarter is primarily due to the lapse in statutes in foreign jurisdictions and foreign exchange gains and losses.

The Company s continuing practice is to recognize interest and/or penalties related to income tax matters in income tax expense. During the three months ended June 30, 2010, the Company increased its liability for interest of $5,000

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related to unrecognized tax benefits. The Company had a recorded liability for interest and potential penalties totaling $1,064,000 at June 30, 2010.

The tax years 2003 to 2009 remain open to examination by the Federal, state and foreign jurisdictions to which we are subject. The Federal statute of limitations for tax years 1997 to 2003 remains open for purposes of adjusting the amounts of net operating losses carried forward from those years. The Company is currently under examination in various foreign locations. The Company anticipates effectively settling the uncertain tax positions relating to certain foreign jurisdictions in the next twelve months. The Company does not believe the amount settled will materially differ from the unrecognized tax benefit as of June 30, 2010.

The Company believes it has adequately provided for income tax issues not yet resolved with federal, state and foreign tax authorities. Although not probable, the most adverse resolution of these issues could result in additional charges to earnings in future periods.

Note 10. Segment Information

The Company has prepared operating segment information to report components that are evaluated regularly by the Company s chief operating decision maker in deciding how to allocate resources and in assessing performance.

The Company s reportable operating segments include software licenses, consulting, maintenance and hardware and other. Currently, the Company does not separately allocate amortization of intangible assets or operating expenses to these segments, nor does it allocate specific assets to these segments. Therefore, the segment information reported includes only revenues, cost of segment revenues and segment gross profit. Excluded from the table below is amortization of intangible assets for the three months ended June 30, 2010 and 2009, of $7,051,000 and $8,221,000, respectively, and amortization of intangible assets for the six months ended June 30, 2010 and 2009, of $14,108,000 and $16,626,000, respectively.

Operating segment data for the three and six months ended June 30, 2010 and 2009 is as follows (*in thousands*):

	Licenses	Consulting	Maintenance	Hardware and Other	Total
Three months ended June 30, 2010:					
Revenues	$ 19,160	$ 34,344	$ 47,503	$ 8,158	$ 109,165
Cost of revenues	4,718	27,874	11,876	7,170	51,638
Gross profit	$ 14,442	$ 6,470	$ 35,627	$ 988	$ 57,527
Three months ended June 30, 2009:					
Revenues	$ 17,533	$ 32,061	$ 47,340	$ 3,513	$ 100,447
Cost of revenues	3,850	26,079	11,023	3,057	44,009
Gross profit	$ 13,683	$ 5,982	$ 36,317	$ 456	$ 56,438
Six months ended June 30, 2010:					
Revenues	$ 35,396	$ 65,433	$ 95,463	$ 12,154	$ 208,446
Cost of revenues	8,252	53,675	23,816	10,679	96,422

Gross profit	$ 27,144	$ 11,758	$ 71,647	$ 1,475	$ 112,024
Six months ended June 30, 2009:					
Revenues	$ 30,710	$ 63,512	$ 94,206	$ 10,711	$ 199,139
Cost of revenues	6,279	52,493	21,989	9,431	90,192
Gross profit	$ 24,431	$ 11,019	$ 72,217	$ 1,280	$ 108,947

Note 11. Venezuela Currency Devaluation

The Company conducts limited operations in Venezuela (revenue derived from Venezuelan operations represented less than 0.01% of the Company s consolidated revenue for the six months ended June 30, 2010). In January 2010, the government of Venezuela devalued its bolivar currency from 2.15 to 4.30 bolivares per United States dollar. As a result of the devaluation, the Company reduced its cash and working capital balances by and incurred a foreign currency charge of $1,315,000 due to the revaluing of its bolivar-based net assets. This charge is included in

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EPICOR SOFTWARE CORPORATION

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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interest and other income (expense), net in the Condensed Consolidated Statements of Operations and Comprehensive Loss.

Note 12. Commitments and Contingencies

Litigation

The Company is subject to legal proceedings and claims in the normal course of business. The Company is currently defending these proceedings and claims, and anticipates that it will be able to resolve these matters in a manner that will not have a material adverse effect on the Company s consolidated financial position, results of operations or cash flows.

Guarantees

The Company from time to time enters into certain types of contracts that contingently require the Company to indemnify parties against third-party claims. These contracts primarily relate to: (i) divestiture and acquisition agreements, under which the Company may provide customary indemnifications to either (a) purchasers of the Company s businesses or assets; or (b) entities from whom the Company is acquiring assets or businesses; (ii) certain real estate leases, under which the Company may be required to indemnify property owners for environmental and other liabilities and other claims arising from the Company s use of the applicable premises; (iii) certain agreements with the Company s officers, directors and employees, under which the Company may be required to indemnify such persons for liabilities arising out of their relationship with the Company; (iv) Company license and consulting agreements with its customers, under which the Company may be required to indemnify such customers for intellectual property infringement claims and other claims arising from the Company s provision of services to such customers and (v) Company distribution agreements with its distributors and resellers, under which the Company may be required to indemnify such distributors or resellers against property infringement claims.

Note 13. New Accounting Pronouncements

In January 2010, the FASB issued an update to existing accounting standards to improve disclosures regarding fair value measurements and, thus, increase the transparency in financial reporting. The update provides that a reporting entity should disclose separately the amounts of significant transfers in and out of Level 1 and Level 2 fair value measurements and describe the reasons for the transfers; and in the reconciliation for fair value measurements using significant unobservable inputs (Level 3), a reporting entity should present separately information about purchases, sales, issuances, and settlements. In addition, the update clarifies the requirements of the existing disclosures as follows: (1) For purposes of reporting fair value measurement for each class of assets and liabilities, a reporting entity needs to use judgment in determining the appropriate classes of assets and liabilities; and (2) a reporting entity should provide disclosures about the valuation techniques and inputs used to measure fair value for both recurring and nonrecurring fair value measurements (for measurements in Level 2 and Level 3). The update is effective for interim and annual reporting periods beginning after December 15, 2009, except for the disclosures about purchases, sales, issuances, and settlements in the roll forward of activity in Level 3 fair value measurements. Those disclosures are effective for fiscal years beginning after December 15, 2010, and for interim periods within those fiscal years. The Company adopted the provisions that were in effect as of December 15, 2009, and the adoption did not have an impact on the consolidated financial statements. The Company will adopt the remaining provisions as they become effective. The Company does not expect adoption to have a material impact on the consolidated financial statements.

In October 2009, the FASB issued new accounting guidance for revenue recognition for multiple-deliverable revenue arrangements. The objective of this guidance is to address the accounting for multiple-deliverable arrangements to enable vendors to account for products or services (deliverables) separately rather than as a combined unit as well as eliminate the use of the residual method for use in allocating contractual consideration and replace it with the relative selling price method. Vendors often provide multiple products or services to their customers. Those deliverables often are provided at different points in time or over different time periods. This update provides amendments to the criteria in Accounting Standards Codification (ASC) Subtopic 605-25 for allocating consideration in multiple-deliverable arrangements. The amendments in this update establish a selling price hierarchy for determining the selling price of a deliverable. The selling price used for each deliverable will be based on vendor-specific objective evidence if available, third-party evidence if vendor-specific objective evidence is not available, or estimated selling price if neither vendor-specific objective evidence nor third-party evidence is available. The amendments in this update also will replace the term fair value in the revenue allocation guidance with selling price to clarify that the allocation of revenue is based on entity-specific assumptions rather than

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assumptions of a marketplace participant. Additionally, the new guidance is only applicable to non-software related deliverables sold as part of a multiple-deliverable arrangement. In an arrangement that includes software deliverables as well as non-software related deliverables, the provisions of ASC Topic 985 would apply to the software deliverables. This update is effective for fiscal years beginning on or after June 15, 2010; however, early adoption is permitted. The Company is currently evaluating the impact, if any, of this new accounting update on its consolidated financial statements.

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Item 2 Management s Discussion and Analysis of Financial Condition and Results of Operations:

Forward Looking Statements Safe Harbor

Certain statements in this Quarterly Report on Form 10-Q are forward looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities and Exchange Act of 1934, as amended, that involve risks and uncertainties. Any statements contained herein (including without limitation statements to the effect that the Company or Management estimates, expects, anticipates, plans, believes, projects, continues, should, may, or will or statements concerning potential or opportunity or vari comparable terminology or the negative thereof) that are not statements of historical fact should be construed as forward-looking statements including statements about (i) the Company s future financial results, (ii) the impact of new accounting pronouncements, (iii) the Company s product development plans, (iv) the Company s capital spending, (v) the Company s future cash flow from operations, (vi) sufficient sources of financing to continue operations for next twelve months and to satisfy contractual obligations and commercial commitments, (vii) the effect of current legal proceedings, (viii) payment of obligations related to the Company s restructurings, (ix) the future use of forward or other hedging contracts, (x) the future impact of recent acquisitions on the Company, (xi) future investments in product development, (xii) schedule of amortization of intangible assets, (xiii) future impact of valuation allowance review and (xiv) future expense levels. Actual results could differ materially and adversely from those anticipated in such forward looking statements as a result of certain factors, including the factors listed at pages 36 to 44. Because these factors may affect the Company s operating results, past performance should not be considered an indicator of future performance and investors should not use historical results to anticipate results or trends in future periods. The Company undertakes no obligation to revise or publicly release the results of any revision to these forward-looking statements. Investors should carefully review the risk factors described below and in other documents the Company files from time to time with the Securities and Exchange Commission, including the Company s Annual Report on Form 10-K.

The following discussion should be read in conjunction with the consolidated financial statements and notes thereto.

Overview

Epicor Software Corporation (Epicor or the Company) designs, develops, markets and supports enterprise application software solutions and services primarily for use by midsized companies and the divisions and subsidiaries of Global 1000 enterprises, which generally consist of companies with annual revenues between $25 million and $1 billion, and emerging enterprises, which generally consist of rapidly growing businesses with annual revenues under $25 million. Epicor s solutions are designed to help companies focus on their customers, suppliers, partners and employees through enterprise-wide management of resources and information. This collaborative focus distinguishes the Company from conventional enterprise resource planning (ERP) vendors, whose primary focus is improving internal business processes and efficiencies. The Company believes that by automating and integrating information and critical business processes across their entire value chain, enterprises can improve, not just their bottom line, but also their top line, allowing them to compete more effectively in today s increasingly global economy.

Epicor generates its revenues through three principal lines of business: i) the sale of software licenses, ii) the sale of consulting services primarily to implement the software it sells for its customers; and iii) the sale of maintenance services to support the ongoing use of the Company s software by its customers. In addition, Epicor sells a small amount of hardware, which consists primarily of servers and point-of-sales systems for customers who would like the Company s software pre-loaded prior to shipping.

One of the most important aspects of the Company s business is the sale of software licenses to new name customers, as most of the other revenues generated by the Company including the sale of consulting services and maintenance services, as well as the sale of additional software licenses are dependent on the initial sale of software to a new customer. Following the release of Epicor 9 in December of 2008, sales to new name customers have been relatively strong. Epicor 9 has expanded the scope of the Company s addressable markets by providing additional features and functionality that enable Epicor to meet the ERP software requirements of significantly more companies throughout the world. As such, despite the fact that none of the markets or vertical industries the Company has traditionally served have resumed spending levels anywhere close to the levels of 2007 or 2008, Epicor is seeing relatively strong sales of software licenses to new name customers as its total addressable market has expanded. Sales to new name customers have been particularly strong in the Americas, as well as in Europe, the Middle East, and Asia. Epicor continues to invest in additional features, functionality, languages and localizations

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for Epicor 9 to further expand its addressable markets. Research and development and sales and marketing expenses have increased in the first half of 2010 when compared to the first half of 2009 as a result of these investments, as well as a result of additional compensation expense. While the Company believes it will continue to see relatively strong sales of license revenues into new name customer throughout the world, further economic deterioration in the Americas or internationally could have a significant impact on the Company s ability to generate revenue from new name software license sales.

Epicor also generates software license revenue from its existing base of customers. Historically, sales of software licenses into its base of existing customers consist primarily of existing customers purchasing new features and functionality or additional user software licenses, as well as upgrades to another of the Company s software products, particularly when the Company has recently released a new product such as Epicor 9. As economies throughout the world continue to face uncertain times, sales of software licenses into the Company s base of existing customers has been more difficult as the Company s existing customers are more reluctant to add new features and functionality, nor are they inclined to upgrade to a new product. The Company is also selling fewer additional seat licenses as most of the Company s existing customers are not growing and are not engaged in merger and acquisition activity. As economies throughout the world improve, Epicor believes spending by its existing base of customers will gradually increase and that revenue contribution from this group of customers will get better.

Toward the end of 2009 and in 2010, the Company began to see some signs of improvement in the markets it targets, which is beginning to be reflected primarily in higher software license revenues when compared to the year earlier period, particularly as the Company has expanded its addressable markets for the sale of Epicor 9 into new name customers. Specifically, all revenue lines for the 2010 second quarter and year to date each exceeded the 2009 second quarter and year to date revenues. While there are increasing signs of economic recovery throughout the world, which the Company believes may benefit its future revenue streams, the Company continues to monitor the economic situation, the business environment and the Company s outlook.

Total revenues for the three months ended June 30, 2010, increased 8.8% to $109.3 million, compared to $100.4 million for the three months ended June 30, 2009. Net license revenue increased by 9.3% to $19.2 million for the three months ended June 30, 2010, when compared to net license revenue of $17.5 million for the three months ended June 30, 2009. Consulting revenue was $34.4 million for the three months ended June 30, 2010, an increase of 7.1% compared to consulting revenue of $32.1 million for the three months ended June 30, 2009. Maintenance revenue for the three months ended June 30, 2010 was $47.5 million, an increase of 0.3% compared to maintenance revenue of $47.3 million for the three months ended June 30, 2009. Hardware and other revenue for the three months ended June 30, 2010 was $8.2 million, an increase of 132.2% compared to hardware and other revenue of $3.5 million for the three months ended June 30, 2009. See discussion in Results of Operations for more detailed information.

Total revenues for the six months ended June 30, 2010, increased 4.7% to $208.4 million, compared to $199.1 million for the six months ended June 30, 2009. Net license revenue increased by 15.3% to $35.4 million for the six months ended June 30, 2010, when compared to net license revenue of $30.7 million for the six months ended June 30, 2009. Consulting revenue was $65.4 million for the six months ended June 30, 2010, an increase of 3.0% compared to consulting revenue of $63.5 million for the six months ended June 30, 2009. Maintenance revenue for the six months ended June 30, 2010 was $95.5 million, an increase of 1.3% compared to maintenance revenue of $94.2 million for the six months ended June 30, 2009. Hardware and other revenue for the six months ended June 30, 2010 was $12.1 million, an increase of 13.5% compared to hardware and other revenue of $10.7 million for the six months ended June 30, 2009. See discussion in Results of Operations for more detailed information.

Overall gross margin was 46.2% for the three months ended June 30, 2010, compared to 48.0% during the same period in 2009. The decrease is primarily due to increased third-party royalty costs. Overall gross margin was 47.0% for the six months ended June 30, 2010, compared to 46.4% during the same period in 2009, up primarily due to decreased cost of sales, primarily in consulting as a result of cost cutting efforts made by the Company.

Cash flows from operations were $14.2 million for the six months ended June 30, 2010, compared to 2009 cash flows from operations of $15.7 million. Cash flows from operating activities decreased due primarily to an increase in inventory balances for expected customer roll outs and a decrease in other accrued liabilities due to payment of prior year bonuses, and changing the current year s bonus plan to a stock-based, noncash, bonus plan.

The Company reported a net loss of $1.0 million, or a loss of $0.02 per diluted share, for the three months ended June 30, 2010, compared to a net loss of $6.7 million, or a loss of $0.11 per diluted share, for the three months ended

June 30, 2009. Net loss for the three months ended June 30, 2010 and 2009, included significant non-cash charges primarily consisting of amortization of intangible assets of $7.1 million and $8.2 million, stock-based compensation expense of $3.5 million and $1.6 million, and amortization of long-term debt discount of $2.1 million and $2.0 million, respectively. Net loss for the three months ended June 30, 2010 and 2009 also includes restructuring and other charges of $2.6 million and a credit of $0.2 million, respectively, and a gain on the change in the fair value of our interest rate swaps of $0.1 million and $0, respectively.

The Company reported a net loss of $1.0 million, or a loss of $0.02 per diluted share, for the six months ended June 30, 2010, compared to a net loss of $8.3 million, or a loss of $0.14 per diluted share, for the six months ended June 30, 2009. Net loss for the six months ended June 30, 2010 and 2009, included significant non-cash charges primarily consisting of amortization of intangible assets of $14.1 million and $16.6 million, stock-based compensation expense of $7.7 million and $4.1 million, amortization of long-term debt discount of $4.2 million and $3.9 million, Venezuela currency devaluation of $1.3 million and $0, and the write-off of debt issuance fees of $0 and $0.9 million, respectively. Net loss for the six months ended June 30, 2010 and 2009 also includes restructuring and other charges of $2.7 million and $1.2 million, respectively, and a gain on the change in fair value of our interest rate swaps of $0.1 million and $0, respectively. The net loss for the six months ended June 30, 2009 excludes approximately $0.4 million of revenues that would have been recorded if NSB s deferred revenues had not been adjusted to fair value in purchase accounting.

Foreign Currency

The Company has operations in foreign countries around the world and these operations generate revenue and incur expenses in currencies other than the U.S. dollar, particularly the Australian dollar, Canadian dollar, euro, British pound, Mexican peso, Malaysian ringgit and Japanese yen. For revenue and expenses denominated in a currency other than the U.S. dollar, the Company calculates constant currency comparisons by converting current period financials at the average monthly exchange rates applicable to prior periods. The following table summarizes the changes, in both U.S. dollar and percentages, due to currency fluctuations for the three and six months ended June 30, 2010, compared to the same periods of 2009 *(in thousands except percentages)*:

	Three months ended June 30,		Six months ended June 30,	
2010 vs. 2009	**Change $**	**Change %**	**Change $**	**Change %**
Total revenues	$ 143	0.1%	$ 3,201	1.6%
Cost of revenues (including amortization)	$ 1,071	1.9%	3,642	3.4%
Operating expenses	$ 633	1.3%	2,651	2.8%

For the three and six months ended June 30, 2010, the average foreign currency exchange rates for the U.S. dollar weakened against the group of foreign currencies (taken as a whole) in which the Company conducts business as compared to the average exchange rates for the similar periods last year. As a result, the weakening U.S. dollar increased the Company s reported revenues, cost of revenues and operating expenses compared to what would have been reported in the corresponding periods of last year.

Critical Accounting Policies

The consolidated financial statements are prepared in conformity with United States of America generally accepted accounting principles (GAAP). As such, management is required to make judgments, estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. The significant accounting policies which are most critical to aid in fully understanding and evaluating reported financial results include the following:

Revenue Recognition

The Company enters into contractual arrangements with end-users that may include licensing of the Company s software products, product support and maintenance services, consulting services, resale of third-party hardware or various combinations thereof, including the sale of such products or services separately. The Company s accounting

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policies regarding the recognition of revenue for these contractual arrangements is fully described in Note 6 of Notes to Condensed Consolidated Financial Statements.

The Company considers many factors when applying accounting principles generally accepted in the United States of America related to revenue recognition. These factors include, but are not limited to:

- The actual contractual terms, such as payment terms, delivery dates and pricing of the various product and service elements of a contract;
- Availability of products to be delivered;
- Time period over which services are to be performed;
- Creditworthiness of the customer;
- The complexity of customizations and integrations to the Company s software required by service contracts;
- The sales channel through which the sale is made (direct, value added reseller (VAR), distributor, etc.);
- Discounts given for each element of a contract;
- Any commitments made as to installation or implementation go live dates; and
- Whether vendor specific objective evidence of the fair value of undelivered elements exists.

Each of the relevant factors is analyzed to determine its impact, individually and collectively with other factors, on the revenue to be recognized for any particular contract with a customer. Management is required to make judgments regarding the significance of each factor in applying the revenue recognition standards, as well as whether or not each factor complies with such standards. Any misjudgment or error by management in its evaluation of the factors and the application of the standards, especially with respect to complex or new types of transactions, could have a material adverse effect on the Company s future revenues and operating results.

Allowance for Doubtful Accounts

The Company s accounts receivable go through a collection process that is based on the age of the invoice and requires attempted contacts with customers at specified intervals and assistance from other personnel within the Company who have a relationship with the customer. The Company writes off accounts to its allowance when the Company has determined that collection is not likely. The Company believes no significant concentrations of credit risk existed at June 30, 2010. Receivables from customers are generally unsecured.

The Company maintains an allowance for doubtful accounts based on historical collections performance and specific collection issues. If actual bad debts differ from the reserves calculated, the Company records an adjustment to bad debt expense in the period in which the difference occurs. Such adjustment could result in additional charges to the Company s results of operations.