WAGEWORKS, INC.
Form 10-Q
August 04, 2014

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended June 30, 2014

OR

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

For the transition period from____________ to ____________

Commission File Number: 001-35232

WAGEWORKS, INC.

(Exact name of Registrant as specified in its charter)

Delaware	94-3351864
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

San Mateo, California 1100 Park Place, 4th Floor San Mateo, California	94403
(Address of principal executive offices	(Zip Code)

(650) 577-5200

(Registrant's telephone number, including area code)

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

Indicate by check mark whether the registrant has submitted electronically and posted to 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.

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

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

As of July 28, 2014, there were 35,191,857 shares of the registrant's common stock outstanding.

WAGEWORKS, INC.

FORM 10-Q QUARTERLY REPORT

Table of Contents

Table of Contents

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

WAGEWORKS, INC.

Consolidated Balance Sheets

(In thousands, except per share amounts)

	December 31, 2013 Derived from Audited Financial Statements	June 30, 2014 (unaudited)
Assets		
Current assets:		
Cash and cash equivalents	$ 359,958	$ 370,894
Restricted cash	331	332
Accounts receivable, net	32,863	38,899
Deferred tax assets - current	1,985	2,027
Prepaid expenses and other current assets	10,135	10,971
Total current assets	405,272	423,123
Property and equipment, net	26,532	27,691
Goodwill	97,636	97,591
Acquired intangible assets, net	42,786	43,764
Deferred tax assets	10,666	10,624
Other assets	16,763	13,672
Total assets	$ 599,655	$ 616,465
Liabilities and Stockholders' Equity		
Current liabilities:		
Accounts payable and accrued expenses	$ 49,419	$ 43,205
Customer obligations	281,153	280,186
Short-term contingent payment	4,265	3,111
Other current liabilities	1,592	577
Total current liabilities	336,429	327,079
Long-term debt	29,448	29,486

Long-term contingent payment, net of current portion	3,802	1,806
Deferred tax liability	—	837
Other non-current liability	1,844	1,153
Total liabilities	371,523	360,361
Stockholders' Equity:		
Common stock, $0.001 par value. Authorized 1,000,000 shares; issued 34,746 shares at December 31, 2013 and 35,185 shares at June 30, 2014	35	36
Additional paid-in capital	270,519	287,459
Accumulated deficit	(42,422)	(31,391)
Total stockholders’ equity	228,132	256,104
Total liabilities and stockholders’ equity	$ 599,655	$ 616,465

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

Table of Contents

WAGEWORKS, INC.

Consolidated Statements of Income

(In thousands, except per share amounts)

(Unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2013	2014	2013	2014
Revenues:				
Healthcare	$ 33,871	$ 37,592	$ 69,598	$ 77,576
Commuter	14,722	15,050	29,429	31,093
Other	5,968	6,115	11,649	12,708
Total revenue	54,561	58,757	110,676	121,377
Operating expenses:				
Cost of revenues (excluding amortization of internal use software)	19,932	21,157	40,545	43,954
Technology and development	5,750	5,298	11,567	10,497
Sales and marketing	8,409	9,332	16,924	18,699
General and administrative	9,008	10,539	18,217	20,471
Amortization and change in contingent consideration	4,725	4,549	9,187	8,969
Total operating expenses	47,824	50,875	96,440	102,590
Income from operations	6,737	7,882	14,236	18,787
Other income (expense):				
Interest income	6	1	13	2
Interest expense	(369)	(254)	(747)	(511)
Other income	14	11	33	24
Income before income taxes	6,388	7,640	13,535	18,302
Income tax provision	(2,396)	(3,053)	(4,907)	(7,271)
Net income	$ 3,992	$ 4,587	$ 8,628	$ 11,031
Basic net income per share	$ 0.12	$ 0.13	$ 0.26	$ 0.32
Diluted net income per share	$ 0.11	$ 0.13	$ 0.25	$ 0.30

Shares used in basic net income per share calculations	33,473	35,117	32,853	34,975
Shares used in diluted net income per share calculations	35,047	36,340	34,448	36,323

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

Table of Contents

WAGEWORKS, INC.

Consolidated Statements of Cash Flows

(In thousands)

(Unaudited)

	Six Months Ended June 30,	
	2013	2014
Cash flows from operating activities:		
Net income	$ 8,628	$ 11,031
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	1,831	1,621
Amortization and change in contingent consideration	9,187	8,969
Stock-based compensation	3,558	6,278
Loss on disposal of fixed assets	82	14
Provision for doubtful accounts	(15)	(342)
Deferred taxes	4,372	6,288
Excess tax benefit from the exercise of stock options	(4,908)	(6,428)
Changes in operating assets and liabilities:		
Accounts receivable	(8,868)	(5,767)
Prepaid expenses and other current assets	(2,185)	(723)
Other assets	215	(2,318)
Accounts payable and accrued expenses	1,594	(7,292)
Customer obligations	18,212	(967)
Other liabilities	(2,045)	(640)
Net cash provided by operating activities	29,658	9,724
Cash flows from investing activities:		
Purchases of property and equipment	(7,421)	(7,067)
Cash consideration for business acquisitions, net of cash acquired	(751)	—
Cash paid for acquisition of client contracts	(1,219)	—
Change in restricted cash	3,248	(1)
Net cash used in investing activities	(6,143)	(7,068)
Cash flows from financing activities:		
Proceeds from follow-on offering net of underwriters commissions and discounts	11,550	—
Proceeds from exercise of common stock options	8,825	3,797
Proceeds from issuance of common stock (Employee Stock Purchase Plan)	1,132	1,363

Payment of contingent consideration	—	(3,308)
Excess tax benefit from the exercise of stock options	4,908	6,428
Net cash provided by financing activities	26,415	8,280
Net increase in cash and cash equivalents	49,930	10,936
Cash and cash equivalents at beginning of period	305,052	359,958
Cash and cash equivalents at end of period	$ 354,982	$ 370,894
Supplemental cash flow disclosure:		
Cash paid during the period for:		
Interest	$ 911	$ 444
Taxes	486	82

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

Table of Contents

WAGEWORKS, INC.

Notes to Consolidated Financial Statements

(Unaudited)

(1) Summary of Business and Significant Accounting Policies

Business

WageWorks, Inc., or the Company, is a leader in administering Consumer-Directed Benefits, or CDBs, which empower employees to save money on taxes while also providing corporate tax advantages for employers. The Company is solely dedicated to administering CDBs, including pre-tax spending accounts such as health and dependent care Flexible Spending Accounts, or FSAs, Health Savings Accounts, or HSAs, Health Reimbursement Arrangements, or HRAs, as well as commuter benefit services, including transit and parking programs, wellness programs and other employee spending account benefits, in the United States.

The Company delivers its CDB programs through a highly scalable delivery model that employer clients and their employee participants may access through a standard web browser on any internet-enabled device, including computers, smart phones and other mobile devices such as tablet computers. The Company's on-demand delivery model eliminates the need for its employer clients to install and maintain hardware and software in order to support CDB programs and enables the Company to rapidly implement product enhancements across the Company's entire user base.

The Company's CDB programs assist employees and their families in saving money by using pre-tax dollars to pay for certain of their healthcare, dependent care and commuter expenses. Employers financially benefit from the Company's programs through reduced payroll taxes, even after factoring in the Company's fees. Under the Company's FSA, HSA and commuter programs, employee participants contribute funds from their pre-tax income to pay for qualified out-of-pocket healthcare expenses not fully covered by insurance, such as co-pays, deductibles and over-the-counter medical products or for commuting costs. Under our HRA programs, employer clients provide their employee participants with a specified amount of available reimbursement funds to help their employee participants defray out-of-pocket medical expenses such as deductibles, co-insurance and co-payments. All amounts paid by the employer into HRAs are deductible by the employer as an ordinary business expense and are tax-free to the employee.

The Company operates as a single reportable segment on an entity level basis. The Company generates revenue from the administration of healthcare, commuter and other employer sponsored tax-advantaged benefit services. The entity level is the aggregation of these three revenue streams.

Unaudited Interim Financial Statements

In the opinion of the Company’s management, the unaudited interim consolidated financial statements and condensed notes have been prepared on the same basis as the audited consolidated financial statements and reflect all adjustments that, in the opinion of management, are necessary for a fair presentation of the results for the interim periods presented in accordance with accounting principles generally accepted in the United States of America (GAAP). The results of the interim period presented herein are not necessarily indicative of the results of future periods or annual results for the year ending December 31, 2014.

These unaudited interim consolidated financial statements and condensed notes should be read in conjunction with the December 31, 2013 audited financial statements and related notes, together with management’s discussion and analysis of financial condition and results of operations, included in the Company’s Annual Report on Form 10-K. The December 31, 2013 consolidated balance sheet included in this interim Quarterly Report on Form 10-Q was derived from audited financial statements.

There have been no changes in the Company’s significant accounting policies from those that were disclosed in the Company’s audited consolidated financial statements for the fiscal year ended December 31, 2013 included in the Company’s Annual Report on Form 10-K.

Principles of Consolidation

The unaudited consolidated financial statements include the accounts of the Company and its wholly owned subsidiaries. Acquisitions of businesses are accounted for as business combinations, and accordingly, the results of operations of acquired businesses are included in the consolidated financial statements from the date of acquisition. All intercompany accounts and transactions have been eliminated in consolidation.

Table of Contents

WAGEWORKS, INC.

Notes to Consolidated Financial Statements

(Unaudited)

Use of Estimates

The preparation of financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reporting period. Significant estimates in these consolidated financial statements include allowances for doubtful accounts, estimates of future cash flows associated with assets, asset impairments, useful lives for depreciation and amortization, loss contingencies, expired and unredeemed products, deferred tax assets, reserve for income tax uncertainties, the assumptions used for stock-based compensation, and the assumptions used to fair value contingent consideration associated with acquisitions and purchase accounting. Actual results could differ from those estimates. In making its estimates, the Company considers the current economic and legislative environment in the estimates and has considered those factors when reviewing the assumptions and estimates.

Fair Value of Financial Instruments

Financial Accounting Standards Board (FASB) ASC 820, Fair Value Measurements and Disclosures, or ASC 820, provides a consistent framework to define, measure, and disclose the fair value of assets and liabilities in financial statements. ASC 820 establishes a three-level hierarchy priority for disclosure of assets and liabilities recorded at fair value. The ordering of priority reflects the degree to which objective prices in external active markets are available to measure fair value. The classification of assets and liabilities within the hierarchy is based on whether the inputs to the valuation methodology used for measurement are observable or unobservable.

The Company utilizes valuation techniques that maximize the use of observable inputs and minimize the use of unobservable inputs to the extent possible. The Company determines fair value based on assumptions that market participants would use in pricing an asset or liability in the principal or most advantageous market. When considering market participant assumptions in fair value measurements, the following fair value hierarchy distinguishes between observable and unobservable inputs, which are categorized in one of the following levels:

- Level 1 Inputs: Unadjusted quoted prices in active markets for identical assets or liabilities accessible to the reporting entity at the measurement date.
-

Level 2 Inputs: Other than quoted prices included in Level 1 inputs that are observable for the asset or liability, either directly or indirectly, for substantially the full term of the asset or liability.

· Level 3 Inputs: Unobservable inputs for the asset or liability used to measure fair value to the extent that observable inputs are not available, thereby allowing for situations in which there is little, if any, market activity for the asset or liability at measurement date.

The contingent consideration payables related to the acquisitions of Benefit Concepts, Inc. (BCI) and Crosby Benefit Systems, Inc. (CBS), are recorded at fair value on the acquisition date and are adjusted quarterly to fair value. The increases or decreases in the fair value of contingent consideration payable can result from changes in anticipated revenue levels and changes in assumed discount periods and rates. As the fair value measure is based on significant inputs that are not observable in the market, it is categorized as Level 3.

Table of Contents

WAGEWORKS, INC.

Notes to Consolidated Financial Statements

(Unaudited)

Other financial instruments not measured at fair value on the Company's unaudited consolidated balance sheet at June 30, 2014, but which require disclosure of their fair values include: cash and cash equivalents (including restricted cash), accounts receivable, accounts payable and accrued expenses and debt under the line of credit with MUFG Union Bank, N.A.(formerly Union Bank, N.A.) The estimated fair value of such instruments at June 30, 2014 approximates their carrying value as reported on the consolidated balance sheet. The fair value of all of these instruments are categorized as Level 2 of the fair value hierarchy, with the exception of cash, which is categorized as Level 1.

The following table provides a reconciliation between the beginning and ending balances of items measured at fair value on a recurring basis that used significant unobservable inputs (Level 3) (dollars in thousands):

	Contingent Consideration BCI	Contingent Consideration CBS
Balances at December 31, 2013	5,801	2,266
Gains or losses included in earnings:		
Losses on revaluation of contingent consideration	121	37
Payment of contingent consideration	(3,308)	—
Balances at June 30, 2014	$ 2,614	$ 2,303

The Company measures contingent consideration elements each reporting period at fair value and recognizes changes in fair value in earnings each period in the amortization and change in contingent consideration line item on the consolidated statements of income, until the contingency is resolved.

The Company recorded an immaterial charge related to the change in fair value of the contingent considerations for BCI and CBS, during the three months ended June 30, 2014, as a result of accretion charges due to the passage of time and fair value adjustments due to changes in forecasted revenue levels. During the six months ended June 30, 2014, the Company recorded $0.1 million in charges for BCI and CBS related to changes in fair value of the contingent considerations as a result of accretion charges due to the passage of time and fair value adjustments due to changes in forecasted revenue levels. During the three months ended June 30, 2013, the Company recorded a total of $0.8 million in charges for Choice Strategies (CS), BCI and CBS related to changes in fair value of the contingent considerations, primarily driven by increases in revenue levels achieved and forecasted to be achieved in 2013 for CS. The charges incurred in the three months ended June 30, 2013, are partially offset by a $0.3 million credit related to Fringe Benefits Management (FBM). During the six months ended June 30, 2013, the Company recorded a total of $1.1 million in charges for CS, BCI and CBS related to changes in fair value of the contingent considerations, primarily driven by the CS revenue levels achieved as discussed above and as a result of the passage of time. These charges were also partially offset by the $0.3 million credit related to FBM.

Quantitative Information about Level 3 Fair Value Measurements

The significant unobservable inputs used in the fair value measurement of the Company's contingent consideration designated as Level 3 are as follows:

	Fair Value at June 30, 2014 (in thousands, unaudited)	Valuation Technique	Significant Unobservable Input
Contingent consideration - BCI	$2,614	Discounted cash flow	Annualized revenue and probability of achievement
Contingent consideration - CBS	$2,303	Discounted cash flow	Annualized revenue and probability of achievement

Sensitivity to Changes in Significant Unobservable Inputs

As presented in the table above, the significant unobservable inputs used in the fair value measurement of contingent consideration related to the acquisitions are annualized revenue forecasts developed by the Company's management and the probability of achievement of those revenue forecasts. Significant increases (decreases) in these unobservable inputs in isolation would result in a significantly lower (higher) fair value measurement.

WAGEWORKS, INC.

Notes to Consolidated Financial Statements

(Unaudited)

Recently Issued Accounting Pronouncements

In May 2014, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2014-09, Revenue from Contracts with Customers (Topic 606), which amended the existing accounting standards for revenue recognition. ASU 2014-09 establishes principles for recognizing revenue upon the transfer of promised goods or services to customers, in an amount that reflects the expected consideration received in exchange for those goods or services. It is effective for annual reporting periods and interim reporting periods within that reporting period beginning after December 15, 2016. Early adoption is not permitted. The amendment permits the use of either the retrospective or cumulative effect transition method. The Company is in the process of evaluating the impact of adoption of ASU 2014-09 on its consolidated financial statements.

(2) Net Income per Share

The following table sets forth the computation of basic and diluted net income per share (in thousands, except per share data):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2013	2014	2013	2014
Numerator (basic and diluted):				
Net income	$ 3,992	$ 4,587	$ 8,628	$ 11,031
Denominator (basic):				
Weighted average common shares outstanding	33,473	35,117	32,853	34,975

Denominator (diluted):				
Weighted average common shares outstanding	33,473	35,117	32,853	34,975
Dilutive stock options	1,574	1,223	1,595	1,348
Diluted weighted average common shares outstanding	35,047	36,340	34,448	36,323
Net income per share:				
Basic	$ 0.12	$ 0.13	$ 0.26	$ 0.32
Diluted	$ 0.11	$ 0.13	$ 0.25	$ 0.30

Diluted net income per share does not include the effect of the following anti-dilutive common equivalent shares (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2013	2014	2013	2014
Stock options outstanding	63	50	41	49

(3) Acquisitions and Channel Partner Arrangement

Crosby Benefit Systems, Inc. Acquisition

On May 1, 2013, the Company acquired Crosby Benefit Systems, Inc., or CBS, a third party administrator of CDBs, such as, flexible spending accounts, health reimbursement arrangements, COBRA continuance services, enrollment and eligibility management and commuter programs, based in Newton, Massachusetts. CBS will continue to operate out of the Newton office as a division of the Company. The Company accounted for the acquisition of CBS as a purchase of a business under ASC 805. This acquisition added new customers and participant relationships and further strengthens the Company's position in the Consumer-Directed Benefits market. The aggregate non-contingent portion of the purchase price was $5.0 million and was paid in cash on May 1, 2013.

The purchase price also includes a contingent consideration element that requires the Company to pay the former owners of CBS additional amounts in 2014 and 2015 based upon revenue growth rates of CBS for 2014 and 2015, respectively. The fair value of the contingent element is $2.3 million as of June 30, 2014. The fair value was determined from forecasts developed by management

WAGEWORKS, INC.

Notes to Consolidated Financial Statements

(Unaudited)

based upon existing business and relationships and projected growth rates. As the fair value measure is based on significant inputs that are not observable in the market, the Company categorizes the inputs as Level 3 inputs under ASC 820.

Ceridian Channel Partner Arrangement

In July 2013, the Company entered into a channel partner arrangement with Ceridian Corporation, or Ceridian, a global product and services company, pursuant to which the Ceridian’s CDB account administration business will be substantially transitioned to the Company between October 2013 and January 2015. In conjunction with the transition, the Company also entered into a separate reseller arrangement with Ceridian.

The final purchase price is calculated as a multiple of the expected annual revenue for each employer client successfully transitioned to the Company. The timing of the transition of revenue to the Company is dependent upon the employer clients executing new agreements with the Company and agreeing to a service conversion, a process whose timing and outcome is ultimately controlled by each employer client. In July 2013, the Company made an initial payment of $15.0 million to Ceridian, in advance of any employer clients transitioning over to the Company, which is anticipated to cover a substantial portion of the purchase price. The $15.0 million payment was recorded in other assets in the Company’s consolidated balance sheet. As the employer clients transition to the Company, amounts from the other asset category will be reclassified as an intangible asset and amortization will commence. Through the quarter ended June 30, 2014, the Company has reclassified $5.8 million from other assets to intangible assets in connection with employer clients that have transitioned to the Company and will amortize the intangible assets over an expected life of 7 years.

(4) Intangible Assets

Acquired intangible assets at December 31, 2013 and June 30, 2014 were comprised of the following (dollars in thousands):

	December 31, 2013			June 30, 2014		
	Gross carrying amount	Accumulated amortization	Net	Gross carrying amount	Accumulated amortization	Net
Amortizable intangible assets:						
Client contracts and broker relationships	$ 62,689	$ 25,313	$ 37,376	$ 68,098	$ 28,398	$ 39,700
Trade names	2,240	1,120	1,120	2,240	1,287	953
Technology	9,946	6,850	3,096	9,946	7,958	1,988
Noncompete agreements	2,012	1,745	267	2,012	1,765	247
Favorable lease	1,137	210	927	1,137	261	876
Total	$ 78,024	$ 35,238	$ 42,786	$ 83,433	$ 39,669	$ 43,764

Amortization expense for acquired intangible assets totaled $2.3 million and $2.2 million for the three months ended June 30, 2013 and 2014, respectively. Amortization expense for acquired intangible assets totaled $4.6 million and $4.3 million for the six months ended June 30, 2013 and 2014, respectively.

The estimated expected amortization expense in future periods is as follows (dollars in thousands):

Remainder of 2014	$ 4,638
2015	7,807
2016	6,730
2017	6,404
2018	6,096
Thereafter	12,089
Total	$ 43,764

Table of Contents

WAGEWORKS, INC.

Notes to Consolidated Financial Statements

(Unaudited)

(5) Accounts Receivable

Accounts receivable at December 31, 2013 and June 30, 2014 were comprised of the following (dollars in thousands):

	December 31, 2013	June 30, 2014
Trade receivables	$ 18,398	$ 18,793
Unpaid amounts for benefit services	14,932	20,919
	33,330	39,712
Less allowance for doubtful accounts	(467)	(813)
Accounts receivable, net	$ 32,863	$ 38,899

(6) Property and Equipment

Property and equipment at December 31, 2013 and June 30, 2014 were comprised of the following (dollars in thousands):

	December 31, 2013	June 30, 2014
Computers and equipment	$ 9,960	$ 8,693
Software development costs	64,241	69,907
Furniture and fixtures	2,815	2,995
Leasehold improvements	5,840	5,681
	$ 82,856	$ 87,276
Less accumulated depreciation and amortization	(56,324)	(59,585)
Property and equipment, net	$ 26,532	$ 27,691

In the six months ended June 30, 2014, the Company capitalized software development costs of $6.7 million. In the three months ended June 30, 2013 and 2014, the Company amortized $2.0 million and $2.2 million of capitalized software development costs, respectively. In the six months ended June 30, 2013 and 2014, the Company amortized $3.8 million and $4.3 million of capitalized software development costs, respectively. These costs are included in amortization and change in contingent consideration in the accompanying consolidated statements of income. At June 30, 2014, the unamortized software development costs included in property and equipment in the accompanying consolidated balance sheet was $22.0 million.

Total depreciation expense, including amortization of capitalized software development costs, in the three months ended June 30, 2013 and 2014 was $2.9 million and $3.0 million, respectively, and $5.6 million and $6.0 million in the six months ended June 30, 2013 and 2014, respectively.

(7) Accounts Payable and Accrued Expenses

Accounts payable and accrued expenses at December 31, 2013 and June 30, 2014 were comprised of the following (dollars in thousands):

	December 31, 2013	June 30, 2014
Accounts payable	$ 1,859	$ 931
Payable to benefit providers and transit agencies	23,017	19,402
Accrued payables	6,305	5,763

Accrued compensation and related benefits	13,379	11,724
Other accrued expenses	1,616	1,714
Deferred revenue	3,243	3,671
Accounts payable and accrued expenses	$ 49,419	$ 43,205

Table of Contents

WAGEWORKS, INC.

Notes to Consolidated Financial Statements

(Unaudited)

(8) Employee Benefit Plans

Employee Stock Option Plan

The Company’s stock option program is a long-term retention program that is intended to attract, retain, and provide incentives for talented employees, officers, and directors, and to align stockholder and employee interests. The Company considers its option program critical to its operation and productivity.

The following table summarizes the weighted-average fair value of stock options granted during the period:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2013	2014	2013	2014
Stock options granted (in thousands)	78	723	530	933
Weighted average fair value at date of grant	$ 11.70	$ 17.72	$ 11.69	$ 19.81

Stock option activity for the six months ended June 30, 2014 is as follows (shares in thousands):

	Shares	Weighted average exercise price	Remaining contractual term (years)	Aggregate intrinsic value (dollars in thousands)
Outstanding at December 31, 2013	2,989	$ 11.80	6.55	$ 142,377
Granted	933	42.11		
Exercised	(376)	10.09		
Forfeited	(41)	29.68		
Outstanding as of June 30, 2014	3,505	$ 19.84	7.17	$ 101,376
Vested and expected to vest at June 30, 2014	3,389	$ 19.34	7.09	$ 99,639
Exercisable at June 30, 2014	2,006	$ 9.48	5.62	$ 77,679

As of June 30, 2014, there was $21.1 million of total unrecognized compensation cost related to unvested stock options which are expected to vest. The cost is expected to be recognized over a weighted average period of approximately 3.28 years as of June 30, 2014.

The weighted average assumptions used in the Black-Scholes option pricing model to value option grants during the three and six months ended June 30, 2013 and 2014 were as follows:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2013	2014	2013	2014
Expected volatility	51.51%	47.00%	51.60%	47.08%
Risk-free interest rate	0.80%	1.86%	1.04%	1.87%
Expected term (in years)	5.34	6.08	5.95	6.07
Dividend yield	—%	—%	—%	—%

The determination of the fair value of stock-based awards on the date of grant using an option pricing model is affected by the Company’s stock price as well as assumptions regarding a number of complex and subjective variables. Expected volatility is determined using weighted average volatility of peer publicly traded companies as well as the Company’s own historical volatility. The Company expects that it will increase weighting of its own historical data in future periods, as that history grows over time. The risk-free interest rate is determined by using published zero coupon rates on treasury notes for each grant date given the expected term on the options. The dividend yield of zero is based on the fact that the Company expects to invest cash in operations and has never paid cash dividends on common stock. The Company uses the “simplified” method to estimate expected term as determined under Staff Accounting Bulletin No. 110 due to the lack of option exercise history as a public company.

Table of Contents

WAGEWORKS, INC.

Notes to Consolidated Financial Statements

(Unaudited)

Restricted Stock Units

The Company grants restricted stock units to certain employees, officers, and directors under the 2010 Equity Incentive Plan. Restricted stock units vest upon performance-based, market-based or service-based criteria.

Performance-based restricted stock units vest based on the satisfaction of specific performance criteria. At each vesting date, the holder of the award is issued shares of the Company’s common stock. Compensation expense from these awards is equal to the fair market value of the Company’s common stock on the date of grant and is recognized over the remaining service period based on the probable outcome of achievement of the financial metrics. Management’s estimate of the number of shares expected to vest is based on the anticipated achievement of the specified performance criteria.

Market-based performance restricted stock units are granted such that they vest upon the achievement of certain per share price targets of the Company’s common stock during a specified performance period. The fair market values of market-based performance restricted stock units are determined using the Monte Carlo simulation method. The Monte Carlo simulation method is subject to variability as several factors utilized must be estimated including the future daily stock price of the Company’s common stock over the specified performance period, our stock price volatility and risk-free interest rate. The amount of compensation expense is equal to the per share fair value calculated under the Monte Carlo simulation multiplied by the number of market-based performance restricted stock units granted, recognized over the specified performance period.

Generally, service-based restricted stock units vest over four years with 25% vesting after one year and the balance vesting monthly over the remaining period. Compensation expense is recognized over the requisite service period.

In the first quarter of 2014, the Company granted a total of 106,500 performance-based restricted stock units to certain executive officers and employees. Performance-based restricted stock units are typically granted such that they vest upon the achievement of certain revenue growth rates, and other financial metrics, during a specified performance period for which participants have the ability to receive up to 150% of the target number of shares originally granted.

In the second quarter of 2014, the Company granted a total of 199,000 market-based performance restricted stock units to certain executive officers. The number of shares to be vested is subject to change based on certain market conditions.

Stock-based compensation expense related to restricted stock units was $2.7 million and $3.5 million for the three and six months ended June 30, 2014, respectively. Stock-based compensation expense related to restricted stock units was $0.7 million and $0.9 million for the three and six months ended June 30, 2013, respectively. As of June 30, 2014, there was $23.8 million of total unrecognized compensation cost related to unvested restricted stock units which are expected to vest. The cost is expected to be recognized over a weighted average period of approximately 2.32 years as of June 30, 2014.

The following table summarizes information about restricted stock units issued to officers, directors, and employees under our 2010 Plan:

	Shares (in thousands)	Weighted Average Grant Date Fair Value
Unvested at December 31, 2013	384	$ 24.48
Granted	330	51.05
Vested	(40)	23.97
Forfeitures	(6)	23.76
Unvested at June 30, 2014	668	$ 37.66

Stock-based compensation is classified in the consolidated statements of income in the same expense line items as cash compensation. None of the stock-compensation cost was capitalized as amounts were immaterial. Amounts recorded as expense in the consolidated statements of income are as follows (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2013	2014	2013	2014
Cost of revenue	$ 285	$ 594	$ 398	$ 826
Technology and development	192	287	342	495

13

WAGEWORKS, INC.

Notes to Consolidated Financial Statements

(Unaudited)

Sales and marketing	301	570	486	899
General and administrative	1,707	2,789	2,332	4,058
Total	$ 2,485	$ 4,240	$ 3,558	$ 6,278

(9) Income Taxes

The income tax provision for the three months ended June 30, 2013 and 2014 was $2.4 million and $3.1 million, respectively, and the income tax provision for the six months ended June 30, 2013 and 2014 was $4.9 million and $7.3 million, respectively. The change is primarily due to the increase in income before income taxes for the three and six months ended June 30, 2014 when compared to the three and six months ended June 30, 2013. The Company provides for income taxes using an asset and liability approach, under which deferred income taxes are provided based upon enacted tax laws and rates applicable to periods in which the taxes become payable.

The Company is subject to income taxes in the U.S. federal and various state jurisdictions. Presently, there are no income tax examinations going on in the jurisdictions where the Company operates.

As of June 30, 2014, the Company remains in a net deferred tax asset position. The realization of the Company’s deferred tax assets depends primarily on its ability to generate sufficient U.S. taxable income in future periods. The amount of deferred tax assets considered realizable may increase or decrease in subsequent quarters as management reevaluates the underlying basis for the estimates of future domestic taxable income.

(10) Commitments and Contingencies

(a) Operating Leases

The Company leases office space and equipment under noncancelable operating leases with various expiration dates through 2023. Future minimum lease payments under noncancelable operating leases are as follows (dollars in thousands):

	Operating leases As of June 30, 2014
Remainder of 2014	$ 2,648
2015	6,523
2016	4,809
2017	4,665
2018	4,758
Thereafter	17,046
Total future minimum lease payments	$ 40,449

Rent expense in the three months ended June 30, 2013 and 2014 was $1.1 million and $1.0 million, respectively, and $2.6 million and $1.9 million for the six months ended June 30, 2013 and 2014, respectively.

(b) Legal Matters

The Company is involved from time to time in claims that arise in the normal course of its business. The Company is not presently subject to any material litigation nor, to management's knowledge, is any litigation threatened against the Company that collectively is expected to have a material adverse effect on the Company's cash flows, financial condition or results of operations.

Table of Contents

WAGEWORKS, INC.

Notes to Consolidated Financial Statements

(Unaudited)

(11) Subsequent Events

Amendment to Credit Agreement

On July 21, 2014, the Company, entered into a First Amendment to the Credit Agreement with MUFG Union Bank, N.A. (formerly Union Bank, N.A.), which amends that certain Credit Agreement dated as of December 31, 2012. The First Amendment provides for, among other things, an increase in the revolving credit facility to $125.0 million from $75.0 million and extends the maturity date of the revolving credit facility to July 21, 2017.

Acquisition of CONEXIS

On August 1, 2014, the Company acquired the assets of CONEXIS Benefits Administrators, L.P. (CONEXIS), a subsidiary of The Word & Brown Companies (seller), for $118.0 million in cash, subject to customary working capital adjustments. CONEXIS is a leader in employee benefits administration and serves approximately 16,000 organizations of all sizes. The Company has not completed its initial accounting for this business combination as the valuation of the assets, including intangibles and goodwill acquired, as well as the liabilities assumed, have not been finalized.

The acquisition was made as part of the Company's acquisition growth strategy and will expand the Company's Consumer-Directed Benefits business.

As part of the transaction the Company will retain $10.0 million in cash to satisfy unidentified claims arising post acquisition. If no claims arise within 12 months, the full $10.0 million will be released to seller. The goodwill acquired is expected to be deductible for tax purposes.

15

Table of Contents

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

The following discussion and analysis of our financial condition and results of operations should be read in conjunction with our consolidated financial statements and related notes appearing elsewhere in this Quarterly Report on Form 10-Q. The following discussion and analysis contains forward-looking statements that involve risks and uncertainties, as well as assumptions that, if they never materialize or prove incorrect, could cause our results to differ materially from those expressed or implied by such forward-looking statements. Statements that are not purely historical are forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended (the “Securities Act”), and Section 21E of the Securities Exchange Act of 1934, as amended (the “Exchange Act”). Forward-looking statements are often identified by the use of words such as, but not limited to, “anticipate,” “believe,” “can,” “continue,” “could,” “estimate,” “expect,” “intend,” “may,” “plan,” “project,” “seek,” “should,” “target,” “wi expressions or variations intended to identify forward-looking statements. Such statements include, but are not limited to, statements concerning market opportunity, our future financial and operating results, investment strategy, sales and marketing strategy, management’s plans, beliefs and objectives for future operations, technology and development, economic and industry trends or trend analysis, expectations about seasonality, opportunity for portfolio purchases, use of non-GAAP financial measures, operating expenses, anticipated income tax rates, capital expenditures, cash flows and liquidity. These statements are based on the beliefs and assumptions of our management based on information currently available to us. Such forward-looking statements are subject to risks, uncertainties and other important factors that could cause actual results and the timing of certain events to differ materially from future results expressed or implied by such forward-looking statements. Factors that could cause or contribute to such differences include, but are not limited to, those identified below, and those discussed in the section titled “Risk Factors” included under Part II, Item 1A below. Furthermore, such forward-looking statements speak only as of the date of this report. Except as required by law, we undertake no obligation to update any forward-looking statements to reflect events or circumstances after the date of such events.

Overview

We are a leader in administering Consumer-Directed Benefits, or CDBs, which empower employees to save money on taxes while also providing corporate tax advantages for employers. We are solely dedicated to administering CDBs, including pre-tax spending accounts such as health and dependent care Flexible Spending Accounts, or FSAs, Health Savings Accounts, or HSAs, Health Reimbursement Arrangements, or HRAs, as well as commuter benefit services, including transit and parking programs, wellness programs and other employee spending account benefits, in the United States.

We deliver our CDB programs through a highly scalable delivery model that employer clients and their employee participants may access through a standard web browser on any internet-enabled device, including computers, smart phones and other mobile devices such as tablet computers. Our on-demand delivery model eliminates the need for our employer clients to install and maintain hardware and software in order to support CDB programs and enables us to rapidly implement product enhancements across our entire user base.

Our CDB programs assist employees and their families in saving money by using pre-tax dollars to pay for certain of their healthcare, dependent care and commuter expenses. Employers financially benefit from our programs through reduced payroll taxes, even after factoring in our fees. Under our FSA, HSA and commuter programs, employee participants contribute funds from their pre-tax income to pay for qualified out-of-pocket healthcare expenses not fully covered by insurance, such as co-pays, deductibles and over-the-counter medical products or for commuting costs.

These employee contributions result in savings to both employees and employers. As an example, based on our average employee participant's annual FSA contribution of approximately $1,300 and an assumed personal combined federal and state income tax rate of 35%, an employee participant will reduce his or her taxes by approximately $455 per year by participating in an FSA. Our employer clients also realize payroll tax (i.e., FICA and Medicare) savings on the pre-tax contributions made by their employees. In the above FSA example, an employer client would save approximately $56 per participant per year, even after the payment of our fees.

Under our HRA programs, employer clients provide their employee participants with a specified amount of available reimbursement funds to help their employee participants defray out-of-pocket medical expenses such as deductibles, co-insurance and co-payments. All amounts paid by the employer into HRAs are deductible by the employer as an ordinary business expense and are tax-free to the employee.

Benefit plan years customarily run concurrently with the calendar year and have an open enrollment period that typically occurs at benefit plan year-end during the fourth quarter of the calendar year. Most of our healthcare CDB agreements are executed in the last quarter of the calendar year. Because the signing of our contract often coincides with open enrollment, employer clients are able to offer our CDB programs to their employees during open enrollment for the upcoming benefit year. As a result of this timing, we are able to obtain significant visibility into our healthcare-related revenue early on in each plan year because healthcare benefit plans are administered on an annual basis, contractual revenue is based on the number of participants enrolled in our CDB programs on a per month basis and the minimum number of enrolled participants for the plan year is usually established at the close of the open

Table of Contents

enrollment period. In contrast to healthcare CDB programs, enrollment in commuter programs occurs on a monthly basis. Therefore, there is less visibility and some variability in commuter revenue from month-to-month, particularly during the summer vacation period when employee participants are less likely to participate in commuter programs for those months.

Ceridian Channel Partner Arrangement

As part of our continuing efforts to grow our business through the acquisition of employer clients through various means, in July 2013, we entered into a channel partner arrangement with Ceridian, a global product and services company, pursuant to which Ceridian's Consumer-Directed Benefit account administration business will be substantially transitioned to us between October 2013 and January 2015. In conjunction with the transition, we also entered into a separate reseller arrangement with Ceridian.

The final purchase price is calculated as a multiple of the expected annual revenue for each employer client successfully transitioned to us. The timing of the transition of revenue to us is dependent upon the employer clients executing new agreements with us and agreeing to a service conversion, a process whose timing and outcome is ultimately controlled by each employer client. The total purchase price is expected to be in the range of $15.0 million to $16.0 million and will be capitalized as an intangible asset and amortized over its expected life, as employer clients transition. Through the quarter ended June 30, 2014, the Company has reclassified $5.8 million from other assets to intangible assets in connection with employer clients that have transitioned to the Company and will amortize the intangible assets over an expected life of 7 years.

CONEXIS Acquisition

In August 2014, we acquired the assets of CONEXIS Benefits Administrators, L.P., a subsidiary of The Word & Brown Companies, for $118.0 million. We expect to incur incremental operating costs, primarily related to salaries and personnel-related costs, in the remainder of fiscal year 2014 related to CONEXIS. The impact from this acquisition on our results of operations is expected to be accretive for fiscal year 2014.

Key Components of Our Results of Operations

Revenue

We generate revenue from three major sources: healthcare solutions, commuter solutions and other services.

Healthcare Revenue

We derive our healthcare revenue from the service fees paid by our employer clients for the administration services we provide in connection with their employee participants' healthcare FSA, dependent care FSA, HRA and HSA tax-advantaged accounts. Our fee is generally fixed for the duration of the written agreement with our employer client, which is typically three years for our enterprise clients and one to three years for our small-and medium-sized business, or SMB, clients. These fees are paid to us on a monthly basis by our employer clients, and the related services are made available to employee participants pursuant to written agreements between us and each employer client. Almost all of the healthcare benefit plans we service on behalf of our enterprise employer clients are subject to contractual minimum monthly billing amounts. Generally, such minimum billing amounts are subject to upward revision on a monthly basis as our employer clients hire new employees who elect to participate in our programs, but generally are not subject to downward revision when employees leave their employers because we continue to administer those former employee participants' accounts for the remainder of the plan year. For SMB employer clients, the monthly fee remains constant for the plan year unless there is a 10% or greater increase in the number of employee participants in which case it is subject to upward revision. Revenue is recognized monthly as services are rendered under our written service agreements.

We also earn interchange revenue from debit cards used by employee participants in connection with all of our healthcare programs and through our wholesale card program, which we recognize monthly based on reports received from third parties. We also earn revenue from self-service plan kits called Premium Only Plan kits, or POP revenue.

Commuter Revenue

For our Commuter Order Model, or COM, Commuter Account Model, or CAM and Commuter Express, we derive our commuter revenue from monthly service fees paid by our employer clients, interchange revenue that we receive from debit cards used by employee participants in connection with our commuter solutions and revenue from the sale of transit passes used in our commuter solutions. Our fees from employer clients are normally paid monthly in arrears based on the number of employee participants enrolled

Table of Contents

for the month. Most agreements have volume tiers that adjust the per participant price based upon the number of participants enrolled during that month. Revenue is recognized monthly as services are rendered under these written service agreements. We earn interchange revenue from the debit cards used by employee participants in connection with our commuter programs, which we recognize monthly based on reports received from third parties. We also receive commissions from transit passes, which we purchase from various transit agencies on behalf of employee participants. Due to our significant volume, we receive commissions on these passes which we recognize as vendor commission revenue. Commission revenue is recognized on a monthly basis as transactions are placed under written purchase agreements having stipulated terms and conditions, which do not require management to make any significant judgments or assumptions regarding any potential uncertainties.

Revenue from the TransitChek Basic program is based on a percentage of the face value of the transit and parking passes ordered by employer clients and revenue from the TransitChek Premium program is derived from monthly service fees paid by employer clients based on the number of participants. In both programs, revenues also include interchange revenue that we receive from debit cards used by employee participants in connection with our commuter solutions. We also recognize revenue on our estimate of certain passes that will expire unused over the estimated useful life of the passes, as the amounts paid for these passes are nonrefundable to both the employer client and the employee participant.

Other Revenue

We derive other revenue primarily from our Consolidated Omnibus Budget Reconciliation Act, or COBRA, administration services we provide to employer clients for continuation of coverage for participants who are no longer eligible for the employer’s health benefits, such as medical, dental, vision, and for the continued administration of the employee participants’ HRAs and certain healthcare FSAs. Our agreements to provide COBRA services are not consistently structured and we receive fees based on a variety of methodologies. Other services also include enrollment and eligibility services, employee account administration (i.e., tuition and health club reimbursements) and project-related professional fees. Other services revenue is recognized as services are rendered under our written service agreements.

Costs and Expenses

Cost of Revenues (excluding the amortization of internal use software)

Cost of revenues includes the costs of providing services to our employer clients' employee participants.

The primary component of cost of revenues is personnel expenses and the expenses related to our claims processing, product support and customer service personnel. Cost of revenues includes outsourced and temporary help costs, check/ACH payment processing services, debit card processing services, shipping and handling costs for cards and passes and employee participant communications costs.

Cost of revenues also includes the losses or gains associated with processing our large volume of transactions, which we refer to as "net processing losses or gains." In the normal course of our business, we make administrative and processing errors that we cannot bill to our employer clients. For example, we may over-reimburse employee participants for claims they submit or incur the cost of replacing commuter passes that are not received by employee participants. Upon identifying such an error, we record the expense as a processing loss. In certain circumstances, we experience recoveries with respect to these amounts which are recorded as processing gains.

Cost of revenues does not include amortization of internal use software or change in contingent consideration, which are included in amortization and change in contingent consideration, or the cost of operating on-demand technology infrastructure, which is included in technology and development expenses.

Technology and Development

Technology and development expenses include personnel and related expenses for our technology operations and development personnel as well as outsourced programming services, the costs of operating our on-demand technology infrastructure, depreciation of equipment and software licensing expenses. During the planning and post-implementation phases of development, we expense, as incurred, all internal use software and website development expenses associated with our proprietary scalable delivery model. During the development phase, costs incurred for internal use software are capitalized and subsequently amortized once the software is available for its intended use. See "Amortization and Change in Contingent Consideration" below. Expenses associated with the platform content or the repair or maintenance of the existing platforms are expensed as incurred.

Table of Contents

Sales and Marketing

Sales and marketing expenses consist primarily of personnel and related expenses for our sales, client services and marketing staff, including sales commissions for our direct sales force and external agent/broker commission expense, as well as communication, promotional, public relations and other marketing expenses.

General and Administrative

General and administrative expenses include personnel and related expenses of and professional fees incurred by our executive, finance, legal, human resources and facilities departments.

Amortization and Change in Contingent Consideration

Amortization and change in contingent consideration expense includes amortization of internal use software, amortization of acquired intangible assets and changes in contingent consideration in connection with portfolio purchases and acquisitions.

We capitalize internal use software and website development costs incurred during the development phase and we amortize these costs over the technology’s estimated useful life, which is generally four years. These capitalized costs include personnel costs and fees for outsourced programming and consulting services.

We also amortize acquired intangible assets consisting primarily of employer client agreements and relationships and broker relationships. Employer client agreements and relationships and broker relationships are amortized on a straight-line basis over an average estimated life.

We measure acquired contingent consideration payable each reporting period at fair value and recognize changes in fair value in our consolidated statements of income each period, until the final amount payable is determined.

Increases or decreases in the fair value of the contingent consideration payable can result from changes in revenue forecasts, discount rates and risk and probability assumptions. Significant judgment is employed in determining the appropriateness of these assumptions in each period.

Other Income (Expense)

Other income (expense) primarily consists of (i) interest income; (ii) interest expense; and (iii) gain (loss) on other investments.

Provision for Income Taxes

We are subject to taxation in the United States. Income taxes are computed using the asset and liability method, under which deferred tax assets and liabilities are determined based on the difference between the financial statement and tax basis of assets and liabilities using enacted tax rates in effect for the year in which the differences are expected to affect taxable income. As of June 30, 2014, we remain in a net deferred tax asset position. Valuation allowances are established when necessary to reduce net deferred tax assets to the amount expected to be realized.

At December 31, 2013, we had federal and state operating loss carryforwards of approximately $54.6 million and $96.4 million, respectively, available to offset future regular and alternative minimum taxable income. Our federal net operating loss carryforwards expire in the years 2024 through 2033, if not utilized. The state net operating loss carryforwards expire in the years 2017 through 2033. The federal and state net operating loss carryforwards include excess tax deductions related to stock options in the amount of $22.6 million and $16.2 million, respectively. When utilized, the related excess tax benefit will be booked to additional paid-in capital.

The tax law extension enacted with the American Tax Payer Relief Act of 2012 for federal research and development credits expired on December 31, 2013. We have federal and California research and development credit carryforwards of approximately $4.3 million and $2.0 million respectively, available to offset future tax liabilities. The federal research credit carryforwards expire beginning in the years 2022 through 2033, if not fully utilized. The California tax credit carryforward can be carried forward indefinitely.

Our ability to utilize the net operating losses and tax credit carryforwards are subject to restrictions, including limitations in the event of past or future ownership changes as defined in Section 382 of the Internal Revenue Code of 1986, as amended, or IRC, and similar state tax law. In general, an ownership change occurs if the aggregate stock ownership of certain stockholders increases by more than 50 percentage points over such stockholders' lowest percentage ownership during the testing period (generally three years).

Table of Contents

We have considered Section 382 of the IRC and concluded that any ownership change would not diminish our utilization of the net operating loss or research and development credits during the carryover periods.

We make estimates and judgments about our future taxable income that are based on assumptions that are consistent with our plans and estimates. Should the actual amounts differ from our estimates, our provision for income taxes could be materially affected.

Critical Accounting Policies and Significant Management Estimates

There have been no material changes to our critical accounting policies and estimates during the six months ended June 30, 2014, as compared to the critical accounting policies and estimates disclosed in “Management’s Discussion and Analysis of Financial Condition and Results of Operations” included in our Annual Report on Form 10-K for the year ended December 31, 2013.

Table of Contents

Results of Operations

Comparison of the Three and Six Months Ended June 30, 2013 and 2014

Revenue

	Three Months Ended June 30,		Change from	Six Months Ended June 30,		Change from
	2013	2014	prior year	2013	2014	prior year
Revenue:	(in thousands, unaudited)			(in thousands, unaudited)		
Healthcare	$ 33,871	$ 37,592	11%	$ 69,598	$ 77,576	11%
Commuter	14,722	15,050	2%	29,429	31,093	6%
Other	5,968	6,115	2%	11,649	12,708	9%
Total revenue	$ 54,561	$ 58,757	8%	$ 110,676	$ 121,377	10%

Healthcare Revenue

The $3.7 million increase in healthcare revenue for the second quarter of 2014 as compared to the second quarter of 2013 was primarily driven by a $3.2 million increase in FSA and HRA revenue. The FSA and HRA revenue increase was primarily driven by growth in new employee participation in our programs of $1.8 million, an interchange fee revenue increase of $0.9 million due to increased debit card usage as well as an increase in the number of debit cards issued, and $0.3 million in Premium Only Plan kits, or POP revenue, during the second quarter of 2014 compared to the second quarter of 2013. Healthcare revenue was further increased by a $0.6 million increase in HSA revenue, due to growth in employee participation in this program.

The $8.0 million increase in healthcare revenue for the first six months of 2014 as compared to the first six months of 2013 was primarily driven by a $7.0 million increase in FSA and HRA revenue. The FSA and HRA revenue increase was primarily driven by growth in new employee participation in our programs of $3.9 million, interchange fee revenue increase of $1.5 million due to increased debit card usage as well as an increase in the number of debit cards issued, and $1.0 in post-purchase revenues for CBS, which was acquired in May 2013. FSA and HRA also increased by $0.6 million in POP revenue, during the first six months of 2014 compared to the first six months of 2013. The growth in healthcare revenue was further driven by a $1.0 million increase in HSA revenue primarily due to growth in participation of our HSA programs.

Commuter Revenue

The $0.3 million increase in commuter revenue for the second quarter of 2014 as compared to the second quarter of 2013 was driven by a $0.2 million increase in interchange revenue as a result of increased debit card usage as well as an increase in the number of debit cards issued and a $0.1 million increase in our commuter benefit programs due to growth in the number of employee participants in these programs.

The $1.7 million increase in commuter revenue for the first six months of 2014 as compared to the first six months of 2013 was primarily driven by a $0.8 million increase in our commuter benefit programs, due to growth in the number of employee participants in these programs. The remainder of the commuter revenue growth was primarily driven by increased interchange revenue of $0.6 million as a result of increased debit card usage and $0.3 million increase from post-purchase revenue for CBS.

Other Revenue

The $0.1 million increase in other revenue for the second quarter of 2014 as compared to the second quarter of 2013 was primarily driven by the inclusion of post-purchase COBRA revenues for CBS.

The $1.1 million increase in other revenue for the first six months of 2014 as compared to the first six months of 2013 was primarily driven by the inclusion of $0.8 million in post-purchase COBRA revenues for CBS and $0.2 million of other revenue growth primarily driven by COBRA revenue.

Table of Contents

Cost of Revenues

	Three Months Ended June 30,		Change from prior year	Six Months Ended June 30,		Change from prior year
	2013	2014		2013	2014	
	(in thousands, unaudited)			(in thousands, unaudited)		
Cost of revenues (excluding amortization of internal use software)	$ 19,932	$ 21,157	6%	$ 40,545	$ 43,954	8%
Percent of revenue	37%	36%		37%	36%	

The $1.2 million increase in cost of revenues for the second quarter of 2014 as compared to the second quarter of 2013 was primarily driven by increases in outsourced services costs of $0.6 million due to processing and supporting an increased number of employee participants. The increase in cost of revenues was further driven by a $0.3 million increase in stock-based compensation expense due to new grants of performance-based restricted stock units and stock options as well as adjustments to the vesting terms of previously granted performance-based restricted stock units. Cost of revenues was further driven by an increase in salaries and personnel-related costs, primarily due to the inclusion of post-purchase expenses for CBS which was acquired in May 2013.

The $3.4 million increase in cost of revenues for the first six months of 2014 as compared to the first six months of 2013 was primarily driven by increases in outsourced services costs of $2.1 million due to processing and supporting an increased number of employee participants as well as additional post-purchase outsourced services costs for CBS. Cost of revenue was further driven by an increase in postage and printing costs of $0.4 million due to an increase in the number of employee participant accounts and an increase in stock-based compensation expense of $0.4 million due to new grants of performance-based restricted stock units and stock options as well as adjustments to the vesting terms of previously granted performance-based restricted stock units. The remainder of the increase in cost of revenues was primarily driven by an increase in salaries and personnel-related costs due to post-purchase costs related the CBS portfolio purchase.

As we continue to scale our operations, we expect our cost of revenues to increase in dollar amount to support increased employer client and employee participant levels. Cost of revenues will continue to be affected by our portfolio purchases, acquisitions and channel partner arrangements. Prior to migrating to our proprietary technology platforms, these new portfolios often operate with higher service delivery costs that result in increased cost of revenues until we are able to complete the migration process, which typically occurs over the 12- to 24-month period following closing of the portfolio purchase or acquisition.

Technology and Development

	Three Months Ended June 30,		Change from prior year	Six Months Ended June 30,		Change from prior year
	2013	2014		2013	2014	
	(in thousands, unaudited)			(in thousands, unaudited)		
Technology and development	$ 5,750	$ 5,298	-8%	$ 11,567	$ 10,497	-9%
Percent of revenue	11%	9%		10%	9%	

The $0.5 million decrease in technology and development expenses for the second quarter of 2014 as compared to the second quarter of 2013 was primarily due to a reduction in salaries and personnel-related costs due to a reduction in headcount and reductions in temporary help and consulting services as synergies were realized and operations were consolidated.

The $1.1 million decrease in technology and development expenses for the first six months of 2014 as compared to the first six months of 2013 was primarily driven by decreases in salaries and personnel-related costs of $0.7 million, due to a reduction in headcount as we continue to consolidate operations and realize synergies. Technology and development expenses further decreased due to decreases in temporary help and consulting services of $0.4 million as we continue to consolidate projects.

We intend to continue enhancing the functionality of our software platform as part of our continuous effort to improve our employer client and employee participant experience and to maintain and enhance our control and compliance environment. As we realize synergies and consolidate projects, the dollar amount spent on technology and development has decreased. The timing of development and enhancement projects, including whether they are in phases where costs are capitalized or expensed, will significantly affect our technology and development expense both in dollar amount and as a percentage of revenue.

Table of Contents

Sales and Marketing

	Three Months Ended June 30,		Change from prior year	Six Months Ended June 30,		Change from prior year
	2013	2014		2013	2014	
	(in thousands, unaudited)			(in thousands, unaudited)		
Sales and marketing	$ 8,409	$ 9,332	11%	$ 16,924	$ 18,699	10%
Percent of revenue	15%	16%		15%	15%	

The $0.9 million increase in sales and marketing expense for the second quarter of 2014 as compared to the second quarter of 2013 was primarily driven by salaries and personnel-related costs of $0.4 million due to an increase in headcount from the CBS portfolio purchase, as well as increased hiring of sales and marketing personnel resulting from the ongoing implementation of various new sales and marketing programs. Sales and marketing expenses were further driven by an increase in stock-based compensation expense of $0.3 million due to new grants of performance-based restricted stock units and stock options as well as adjustments to the vesting terms of previously granted performance-based restricted stock units.

The $1.8 million increase in sales and marketing expense for the first six months of 2014 as compared to the first six months of 2013 was primarily driven by salaries and personnel-related costs and outsourced services costs of $1.1 million due to hiring sales and marketing personnel to implement various new sales and marketing programs as well as post-purchase costs related to the CBS portfolio purchase. Sales and marketing expenses were further driven by an increase in stock-based compensation expense of $0.4 million due to new grants of performance-based restricted stock units and stock options as well as adjustments to the vesting terms of previously granted performance-based restricted stock units.

We intend to continue to invest in sales, client services and marketing by hiring additional personnel and continuing to build our broker and channel relationships. We also intend to promote our brand through a variety of marketing and public relations activities. As a result, we expect our sales and marketing expenses to increase in dollar amount in future periods.

General and Administrative

	Three Months Ended June 30,		Change from prior year	Six Months Ended June 30,		Change from prior year
	2013	2014		2013	2014	
	(in thousands, unaudited)			(in thousands, unaudited)		
General and administrative	$ 9,008	$ 10,539	17%	$ 18,217	$ 20,471	12%
Percent of revenue	17%	18%		16%	17%	

The $1.5 million increase in general and administrative expenses for the second quarter of 2014 as compared to the second quarter of 2013 was primarily driven by an increase of $1.1 million in stock-based compensation expense, primarily due to new grants of restricted stock units, performance-based restricted stock units and stock options as well as adjustments to the vesting terms of previously granted performance based restricted stock units. General and administrative expenses were further driven by a $0.3 million increase in bad debt expense accruals when compared to a year ago.

The $2.3 million increase in general and administrative expenses for the first six months of 2014 as compared to the first six months of 2013 was primarily driven by an increase of $1.7 million in stock-based compensation expense, primarily due to new grants of restricted stock units, performance-based restricted stock units and stock options as well as adjustments to the vesting terms of previously granted performance-based restricted stock units. General and administrative expenses were further driven by a $0.5 million increase in professional fees primarily due to an increase in legal fees and a $0.4 million increase in bad debt expense when compared to a year ago. These increases were partially offset by decreases in facility costs as we closed and consolidated several locations in fiscal 2013.

As we continue to grow, we expect our general and administrative expenses to continue to increase in dollar amount as we expand general and administrative headcount to support our continued growth.

Income Taxes

	Three Months Ended June 30,		Six Months Ended June 30,	
	2013	2014	2013	2014
	(in thousands, unaudited)		(in thousands, unaudited)	
Income tax provision	$ (2,396)	$ (3,053)	$ (4,907)	$ (7,271)

Our provision for income taxes increased from $2.4 million for the second quarter of 2013 to $3.1 million for the second quarter of 2014 due primarily to the increase in income before income taxes. Our provision for income taxes increased from $4.9 million for the first six months of 2013 to $7.3 million for the first six months of 2014, due primarily to increases in income before taxes. The tax provision for the six months ended June 30, 2013 includes discrete items of $0.4 million primarily in 2012 Federal Research and Development tax credits that were retroactively reinstated by Congress in 2013.

Liquidity and Capital Resources

At June 30, 2014, our principal sources of liquidity were cash and cash equivalents totaling $370.9 million comprised primarily of prefunds by clients of amounts to be paid on behalf of employee participants as well as, in recent years, other cash flows from operating activities.

We believe that our existing cash and cash equivalents and expected cash flow from operations will be sufficient to meet our operating and capital requirements, as well as anticipated cash requirements for potential future portfolio purchases, over at least the next 12 months. We have historically been able to fulfill our obligations as incurred and expect to continue to fulfill our obligations in the future. Our expectation is based on our current and anticipated client retention rates and our continuing funding model in which the vast majority of our enterprise clients provide us with prefunds as more fully described below under "—Prefunds." To the extent these current and anticipated future sources of liquidity are insufficient to fund our future business activities and requirements, including any potential portfolio purchases; we may need to raise additional funds through public or private equity or debt financing. We cannot provide assurance that we will be able to raise additional funds on favorable terms, if at all.

Prefunds

Under our contracts with the vast majority of our enterprise employer clients, we receive prefunds that have been and are expected to continue to be a significant source of cash flows from operating activities. Each prefund is reflected in cash and cash equivalents on our balance sheet with an equivalent customer obligation recorded as a liability as the prefund is received. Changes in these prefunds and corresponding customer obligations are reflected in our cash flows from operating activities. The substantial majority of our SMB employer clients deposit funds into a separate custodial account, and those funds are neither a source of cash flows from operating activities nor reflected on our balance sheet. These SMB employer clients are responsible for maintaining an adequate balance in those custodial accounts to cover their employee participants' claims. We only pay SMB employee participant claims from amounts in the custodial accounts.

The operation of these prefunds for our enterprise employer clients throughout the year typically is as follows: at the beginning of a plan year, these employer clients provide us with prefunds for their FSA and HRA programs based on a percentage of projected spending by the employee participants for the plan year. In the case of our commuter program, at the beginning of each month we receive prefunds based on the employee participants' monthly elections. These prefunds are typically replenished on a weekly basis by our FSA and HRA employer clients and on a monthly basis by our commuter employer clients, in each case, after we have advanced the funds necessary to process employee participants' FSA and HRA claims as they are submitted to us and to pay vendors relating to our commuter programs. As a result, our cash balances can vary significantly depending upon the timing of invoicing of, and payment by, our employer clients of reimbursement for payments we have made on behalf of employee participants. This prefunding activity covers our estimate of approximately one week of spending on behalf of the employer client's employee participants. We do not require a prefund to administer any of our HSA programs because employee participants in these programs only have access to funds they have previously contributed.

MUFG Union Bank Credit Facility

Debt consists of borrowings under a Credit Agreement, or Revolver, with MUFG Union Bank, N.A. (formerly Union Bank, N.A.), or UB, under which, prior to our amendment of the Revolver on July 21, 2014, we could borrow an aggregate principal amount up to $75.0 million, with a $15.0 million subfacility for the issuance of letters of credit. The July 2014 amendment increased the aggregate principal amount that could be borrowed under the Revolver to $125.0 million. At June 30, 2014, we had $29.6 million principal amount outstanding under the Revolver. Prior to the July 2014 amendment, which extended the maturity date of the Revolver to July 21, 2017, the Revolver was scheduled to mature on December 31, 2015.

Prior to the July 2014 amendment, each loan under the Revolver bore interest at a fluctuating rate per annum equal to a prime rate determined in accordance with the terms of the Revolver, plus 0.25%, or at our option, the LIBOR rate determined in accordance with the terms of the Revolver, plus 2.50%. Per the July 2014 amendment, loans under the Revolver bear interest at a fluctuating rate per annum equal to a prime rate determined in accordance with the terms of the Revolver, plus a spread of 0% to 0.25%, or at our option, a LIBOR rate determined in accordance with the Revolver, plus a spread of 1.75% to 2.25%.

Table of Contents

As collateral for the Revolver, the Company granted UB a security interest in substantially all of the Company's assets. All of the Company's material existing and future subsidiaries are required to guaranty the Company's obligations under the Revolver. Such guarantees by existing and future material subsidiaries are and will be secured by substantially all of the property of such material subsidiaries.

The Revolver contains customary affirmative and negative covenants and also has financial covenants relating to a liquidity ratio, a consolidated leverage ratio, a debt service coverage ratio and a minimum consolidated net worth covenant. We are obligated to pay customary commitment fees and letter of credit fees for a facility of this size and type. We are currently in compliance with all financial and non-financial covenants under the Revolver.

The Revolver contains customary events of default, including, among others, payment defaults, covenant defaults, inaccuracy of representations and warranties, cross-defaults to other material indebtedness, judgment defaults, a change of control default and bankruptcy and insolvency defaults. Under certain circumstances, a default interest rate will apply on all obligations during the existence of an event of default under the loan agreement at a per annum rate of interest equal to 2.00% above the applicable interest rate. Upon an event of default, the lenders may terminate the commitments, declare the outstanding obligations payable by us to be immediately due and payable and exercise other rights and remedies provided for under the Revolver.

Cash Flows

The following table presents information regarding our cash and cash equivalents as of December 31, 2013 and June 30, 2014:

	December 31, 2013	June 30, 2014
	(in thousands)	

	(unaudited)
Cash and cash equivalents, end of period	$ 359,958 $ 370,894

The following table presents information regarding our cash flows for the six months ended June 30, 2013 and 2014:

	June 30,	
	2013	2014
	(in thousands)	
	(unaudited)	
Net cash provided by operating activities	$ 29,658	$ 9,724
Net cash used in investing activities	(6,143)	(7,068)
Net cash provided by financing activities	26,415	8,280
Net increase in cash and cash equivalents	$ 49,930	$ 10,936

Cash Flows from Operating Activities

	June 30,	
	2013	2014
	(in thousands)	
	(unaudited)	
Net cash provided by operating activities	$ 29,658	$ 9,724

Net cash from operating activities decreased by $19.9 million during the six months ended June 30, 2014 when compared to the six months ended June 30, 2013, primarily due to the timing of our billing and employer client payments of prefunds in our customer obligations account when compared to a year ago.

Table of Contents

Cash Flows from Investing Activities

	June 30,	
	2013	2014
	(in thousands)	
	(unaudited)	
Net cash used in investing activities	$ (6,143)	$ (7,068)

Net cash used in investing activities consists primarily of our investment in internal use software that is capitalized prior to it being available for its intended use, capital expenditures and purchases of portfolios.

Cash Flows from Financing Activities

	June 30,	
	2013	2014
	(in thousands)	
	(unaudited)	
Net cash provided by financing activities	$ 26,415	$ 8,280

Net cash provided by financing activities decreased $18.1 million during the six months ended June 30, 2014 when compared to the six months ended June 30, 2013, primarily due to cash received from our follow-on offering during the first three months of 2013 of $11.6 million while we did not have a follow-on offering during the first six months of 2014. Cash provided by financing activities further decreased as a result of lower proceeds received from the exercise of common stock options and a contingent consideration payment made for BCI during the six months ended June 30, 2014.

Contractual Obligations

The following table describes our contractual obligations as of June 30, 2014 (unaudited):

	Total	Less than 1 year	1-3 years	3-5 years	More than 5 years
Long-term debt obligations (1)	$ 29,600	$ —	$ 29,600	$ —	$ —
Interest on long-term debt obligations (2)	1,262	421	841	—	—
Operating lease obligations (3)	40,449	6,219	10,057	4,743	19,430
Acquisition payments (4)	5,787	3,627	2,160	—	—
Total	$ 77,098	$ 10,267	$ 42,658	$ 4,743	$ 19,430

(1) Credit facility: as of June 30, 2014, $75.0 million credit facility with a variable interest rate of base rate plus 0.25% per annum or LIBOR plus 2.50% per annum, and a maturity date of December 31, 2015. At June 30, 2014, we had $29.6 million of outstanding principal which is recorded net of debt issuance costs on our balance sheet. The debt issuance costs are not included in the table above.

(2) Estimated interest payments assume the interest rate applicable as of June 30, 2014 of 2.8% per annum on a $29.6 million principal amount.

(3) We lease facilities under non-cancelable operating leases expiring at various dates through 2023.

(4) Estimated undiscounted contingent consideration for companies acquired in 2012 and 2013.

Off-Balance Sheet Arrangements

We have no off-balance sheet arrangements.

Table of Contents

Item 3. Quantitative and Qualitative Disclosures About Market Risk

Market risk represents the risk of loss that may affect our financial position due to adverse changes in financial market prices and rates. We are exposed to market risks related to changes in interest rates.

As of June 30, 2014, we had cash and cash equivalents of $370.9 million. These amounts consist of cash on deposit with banks and money market funds. The cash and cash equivalents are held for working capital purposes. We do not enter into investments for trading or speculative purposes. Due to the short-term nature of these investments, we do not believe that changes in interest rates would have a material impact on our financial position and results of operations. However, declines in interest rates and cash balances will reduce future investment income.

The primary objective of our investment activities is to preserve principal while maximizing yields without significantly increasing risk. This objective is accomplished by making diversified investments, consisting only of investment grade securities. The decrease in interest income from the effect of a hypothetical decrease in short-term interest rates of 10% would not have a material impact on our net income and cash flows.

Our exposure to market risk also relates to the increase or decrease in the amount of interest expense we must pay on our outstanding debt instruments. As of June 30, 2014, we had outstanding principal of $29.6 million under our credit facility. Each loan under the credit facility bears interest at a fluctuating rate per annum equal to a base rate determined in accordance with the credit agreement, plus 0.25%, or, at our option, an interest rate equal to the LIBOR rate determined in accordance with the credit agreement, plus 2.50%, as of June 30, 2014. The increase in interest expense from the effect of a hypothetical change in interest rates of 1% would not have a material impact on our net income and cash flows.

Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

We maintain “disclosure controls and procedures,” as such term is defined in Rule 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, or the Exchange Act, that are designed to ensure that information required to be disclosed by us in reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the rules and forms of the Securities and Exchange Commission, or the SEC, and that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure. In designing and evaluating our disclosure controls and procedures, management recognizes that disclosure controls and procedures, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the disclosure controls and procedures are met. Additionally, in designing disclosure controls and procedures, our management necessarily was required to apply its judgment in evaluating the cost-benefit relationship of possible disclosure controls and procedures.

Subject to the limitations noted above, based on their evaluation at the end of the period covered by this quarterly report on Form 10-Q, our management, with the participation of our Chief Executive Officer and Chief Financial Officer, have evaluated the effectiveness of the Company’s disclosure controls and procedures and have concluded that our disclosure controls and procedures were effective at the reasonable assurance level.

Changes in Internal Control over Financial Reporting

There was no change in our internal control over financial reporting indentified in connection with the evaluation required by Rule 13a-15(d) or the Exchange Act that occurred during the period covered by this Quarterly Report on Form 10-Q that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

Table of Contents

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

From time-to-time, we may be subject to various legal proceedings and claims that arise in the normal course of our business activities. As of the date of this Quarterly Report on Form 10-Q, we are not a party to any litigation whereby the outcome of such litigation, if determined adversely to us, would individually or in the aggregate be reasonably expected to have a material adverse effect on our results of operations, prospects, cash flows, financial position or brand.

Item 1A. Risk Factors

RISK FACTORS

You should carefully consider the risks described below together with the other information set forth in this report, which could materially affect our business, financial condition and future results. The risks described below are not the only risks facing our company. Risks and uncertainties not currently known to us or that we currently deem to be immaterial also may materially adversely affect our business, financial condition and operating results. If any of the following risks is realized, our business, financial condition, results of operations and prospects could be materially and adversely affected. In that event, the trading price of our common stock could decline.

Our business is dependent upon the availability of tax-advantaged consumer-directed benefits to employers and employees and any diminution in, elimination of, or change in the availability of these benefits would materially adversely affect our results of operations, financial condition, business and prospects.

Our business fundamentally depends on employer and employee demand for tax-advantaged Consumer-Directed Benefits, or CDBs. Any diminution in or elimination of the availability of CDBs for employees would materially adversely affect our results of operations, financial condition, business and prospects. In addition, incentives for employers to offer CDBs may also be reduced or eliminated by changes in laws that result in employers no longer realizing financial gain from the implementation of these benefits. If employers cease to offer CDB programs or reduce the number of programs they offer to their employees, our results of operations, financial condition, business and prospects would also be materially adversely affected. We are not aware of any reliable statistics on the growth of CDB programs and cannot assure you that participation in CDB programs will grow.

In addition, if the payroll tax savings employers currently realize from their employees' utilization of CDBs become reduced or unavailable, employers may be less inclined to offer these programs to their employees. If the tax savings currently realized by employee participants by utilizing CDBs were reduced or unavailable, we expect employees would correspondingly reduce or eliminate their participation in such CDB plans. Any such reduction in employer or employee incentives would materially adversely affect our results of operations, financial condition, business and prospects.

Future portfolio purchases and acquisitions are an important aspect of our growth strategy, and any failure to successfully identify, acquire or integrate acquisitions or additional portfolio targets could materially adversely affect our ability to grow our business. In addition, costs of integrating acquisitions and portfolio purchases may adversely affect our results of operations in the short term.

Our recent growth has been, and our future growth will be, substantially dependent on our ability to continue to make and integrate acquisitions and complementary portfolio purchases to expand our employer client base and service offerings. Since 2007, we have completed seven portfolio purchases and one acquisition. Our most recent portfolio purchases of Benefit Concepts, Inc., or BCI, and Crosby Benefit Systems, Inc., or CBS, were completed in December 2012 and May 2013, respectively. Our successful integration of these portfolio purchases and acquisition into our operations on a cost-effective basis is critical to our future financial performance. While we believe that there are numerous potential portfolio purchases that would add to our employer client base and service offerings, we cannot assure you that we will be able to successfully make a sufficient number of such portfolio purchases in a timely and effective manner in order to support our growth objectives. In addition, the process of integrating portfolio purchases and our most recent acquisition may create unforeseen difficulties and expenditures. We face various risks in making portfolio purchases and any acquisition, including:

- our ability to retain acquired employer clients and their associated revenues;
- diversion of management's time and focus from operating our business to address integration challenges;
- our ability to retain or replace key employees from acquisitions and portfolios we acquire;

Table of Contents

- cultural and logistical challenges associated with integrating employees from acquired portfolios into our organization;
- our ability to integrate the combined products, services and technology;
- the migration of acquired employer clients to our technology platforms;
- our ability to cross-sell additional CDB programs to acquired employer clients;
- our ability to realize expected synergies;
- the need to implement or improve internal controls, procedures and policies appropriate for a public company at businesses that, prior to the portfolio purchase or acquisition, may have lacked effective controls, procedures and policies, including, but not limited to, processes required for the effective and timely reporting of the financial condition and results of operations of the acquired business, both for historical periods prior to the acquisition and on a forward-looking basis following the acquisition;
- possible write-offs or impairment charges that result from acquisitions and portfolio purchases;
- unanticipated or unknown liabilities that relate to purchased businesses;
- the need to integrate purchased businesses' accounting, management information, human resources, and other administrative systems to permit effective management; and
- any change in one of the many complex federal or state laws or regulations that govern any aspect of the financial or business operations of our business and businesses we acquire, such as state escheatment laws.

Portfolio purchases and acquisitions may have a short-term material adverse impact on our results of operations, including a potential material adverse impact on our cost of revenues, as we seek to migrate acquired employer clients to our proprietary technology platforms, typically over the succeeding 12 to 24 months, in order to achieve additional operating efficiencies. For example, our cost of revenues in 2013 included additional expenses of $12.1 million due to the purchases of BCI and CBS. Additionally, from time to time, we may incur material costs and charges related to consolidating our operations following our portfolio purchases and acquisitions.

If we are unable to retain and expand our employer client base and establish new channel partnerships, our results of operations, financial condition, business and prospects would be materially adversely affected.

Most of our revenue is derived from the long term, multi-year agreements that we typically enter into with our employer clients. The initial subscription period is typically three years for our larger employer clients, which we refer to as enterprise clients, and one to three years for our SMB clients. We also derive revenue from our channel partner agreements with American Family Life Assurance Company, or Aflac, and Ceridian. We anticipate in the future establishing new channel partnerships with other companies. Our employer clients, however, have no obligation to renew their agreements with us after the initial term and we cannot assure you that our employer clients will continue to renew their agreements at the same rate, if at all. In addition, employer clients transitioning to us from a channel partner have no obligation to enter into agreements with us and, if they do, there is no guarantee that they will renew their agreements with us after the initial transition period.

Moreover, most of our employer clients have the right to cancel their agreements for convenience, subject to certain notice requirements. While few employer clients have terminated their agreements with us for convenience, some of our employer clients have elected not to renew their agreements with us. Our employer clients' renewal rates may decline or fluctuate as a result of a number of factors, including the prices of competing products or services or reductions in our employer clients' spending levels.

Another important aspect of our growth strategy depends upon our ability to maintain our existing channel partner relationships and develop new relationships. No assurance can be given that new channel partners will be found, that any such new relationships will be successful when they are in place, or that business with our current channel partners will increase at the level necessary to support our growth objectives. If our employer clients do not renew their agreements with us, and we are unable to attract new employer clients or channel partners, our revenue may decline and our results of operations, financial condition, business and prospects may be materially adversely affected.

The market for our services and our business may not grow if our marketing efforts do not successfully raise awareness among employers and employees about the advantages of adopting and participating in CDB programs.

Our revenue model is substantially based on the number of employee participants enrolled in the CDB programs that we administer. We devote significant resources to educating both employers and their employees on the potential cost savings available to them from utilizing CDB programs. We have created various marketing, educational and awareness tools to inform employers about the benefits of offering CDB programs to their employees and how our services allow them to offer these benefits in an efficient and cost effective manner. We also provide marketing information to employees that informs them about the potential tax savings they can achieve by utilizing CDB programs to pay for their healthcare, commuter and other benefit needs. However, if more employers and employees do not become aware of or understand these potential cost savings and choose to adopt CDB programs, our results of operations, financial condition, business and prospects may be materially adversely affected.

In addition, there is no guarantee that the market for our services will grow as we expect. For example, the value of our services is directly related to the complexity of administering CDB programs and government action that significantly reduces or simplifies these requirements could reduce demand or pricing for our services. Further, employees may not participate in CDB programs because they have insufficient funds to set aside into such programs, find the rules regarding use of such programs too complex, or otherwise. If the market for our services declines or develops more slowly than we expect, or the number of employer clients that select us to provide CDB programs to their employee participants declines or fails to increase as we expect, our results of operations, financial condition, business and prospects could be materially adversely affected.

Our business and prospects may be materially adversely affected if we are unable to cross-sell our products and services.

A significant component of our growth strategy is the increased cross-selling of products and services to current and future employer clients. In particular, many of our employer clients use only one of our products so we expect our ability to cross-sell our commuter programs to our healthcare program clients and our healthcare programs to our commuter employer clients to be an important part of this strategy. We may not be successful in cross-selling our products and services if our employer clients find our additional products and services to be unnecessary or unattractive. Any failure to sell additional products and services to current and future clients could materially adversely affect our results of operations, financial condition, business and prospects.

We may be unable to compete effectively against our current and future competitors.

The market for our products and services is highly competitive, rapidly evolving and fragmented. We have numerous competitors, including health insurance carriers, such as Aetna, human resources consultants and outsourcers, such as Aon Hewitt, payroll providers, such as ADP, national CDB specialists, such as TASC, and regional third party administrators and commercial banks, such as Bank of America. Many of our competitors, including health insurance carriers, have longer operating histories and significantly greater financial, technical, marketing and other resources than we have. As a result, some of these competitors may be in a position to devote greater resources to the development, promotion, sale and support of their products and services.

In addition, if one or more of our competitors were to merge or partner with another of our competitors, the change in the competitive landscape could materially adversely affect our ability to compete effectively. Our competitors may also establish or strengthen cooperative relationships with our current or future strategic brokers, insurance carriers, payroll services companies, private exchanges, third party advisors or other parties with which we have relationships, thereby limiting our ability to promote our CDB programs with these parties and limiting the number of brokers available to sell or market our programs. If we are unable to compete effectively with our competitors for any of the foregoing reasons, our results of operations, financial condition, business and prospects could be materially adversely affected.

Changes in healthcare, security and privacy laws and other regulations applicable to our business may constrain our ability to offer our products and services.

Changes in healthcare or other laws and regulations applicable to our business may occur that could increase our compliance and other costs of doing business, require significant systems enhancement, or render our products or services less profitable or obsolete, any of which could have a material adverse effect on our results of operations.

The Patient Protection and Affordable Care Act signed into law on March 23, 2010 and related regulations or regulatory actions could adversely affect our ability to offer certain of our CDBs in the manner that we do today or may make CDBs less attractive to some employers. For example, any new laws that increase reporting and compliance burdens on employers may make them less likely to offer CDBs to their employees and instead offer employees benefit coverage through public exchanges. In addition, it is unclear whether the “Cadillac Tax” set to become effective in 2018 will apply proportionately to an employer’s total health care costs including health related CDBs or if health related CDBs will be exempt from the calculation. If employers are less incentivized to offer our CDB programs to employees because of increased regulatory burdens, costs or otherwise, our results of operations and financial condition could be materially adversely affected.

In addition, the numerous federal and state laws and regulations related to the privacy and security of personal health information, in particular those promulgated pursuant to the Health Insurance Portability and Accountability Act of 1996, or HIPAA, require the implementation of administrative, physical and technological safeguards to ensure the confidentiality and integrity of individually identifiable health information in electronic form. We are required to enter into written agreements with all of our employer clients known as Business Associated Agreements. Pursuant to these agreements, and as our employer client’s “Business

Table of Contents

Associate" thereunder, we are required to safeguard all individually identifiable health information of their participating employees and are restricted in how we use and disclose such information. These agreements also contain data security breach notification requirements which, in some circumstances, may be more stringent than HIPAA requirements. As we are unable to predict what changes to HIPAA or other privacy and security laws or regulations might be made in the future, we can't be certain how those changes could affect our business or the costs of compliance.

We plan to extend and expand our products and services and introduce new products and services, and we may not accurately estimate the impact of developing and introducing these products and services on our business.

We intend to continue to invest in technology and development to create new and enhanced products and services to offer our employer clients and their participating employees. During this past year, we have added several new features to our participant site and have continued to enhance the site's mobile compatibility. To increase the value we deliver to our clients, we have also updated the look and feel of our client facing website with the addition of a new graphic dashboard providing users access to key metrics. Scalability of our platform also remains an on-going focus as our platform volume increases. We continue to make investments in technology stack upgrades, to ensure stability and performance of our applications for our clients and participants. Our health and wellness offerings continue to be expanded to include online claims for our wellness product and the integration of a Wellness Portal to provide our users with the most up-to-date health and wellness information. We have limited experience in these areas and so we may not be able to anticipate or manage new risks and obligations or legal, compliance or other requirements that may arise. The anticipated benefits of such new and improved products and services may not outweigh the costs and resources associated with their development.

Our ability to attract and retain new employer clients and increase revenue from existing employer clients will depend in large part on our ability to enhance and improve our existing products and services and to introduce new products and services. The success of any enhancement or new product or service depends on several factors, including the timely completion, introduction and market acceptance of the enhancement or new product or service. Any new product or service we develop or acquire may not be introduced in a timely or cost-effective manner and may not achieve the broad market acceptance necessary to generate significant revenue. If we are unable to successfully develop or acquire new products or services or enhance our existing products or services to meet client requirements, our results of operations, financial condition, business or prospects may be materially adversely affected.

If we fail to manage future growth effectively, we may not be able to market and sell our products and services successfully.

We have expanded our operations significantly in recent years and anticipate that further expansion will be required in order for us to grow our business. If we do not effectively manage our growth, the quality of our services could suffer, which could materially adversely affect our results of operations, financial condition, business and prospects, and damage our brand and reputation among existing and prospective clients. In order to manage our future growth, we will need to hire, integrate and retain highly skilled and motivated employees. We will also be required to continue to improve our existing systems for operational and financial information management, including our reporting systems, procedures and controls and regulatory compliance processes. These improvements may require significant capital expenditures and will place increasing demands on our management. We may not be successful in managing or expanding our operations, or in maintaining adequate operating and financial information systems and controls. If we are not successful in implementing improvements in these areas, our results of operations, financial condition, business and prospects would be materially adversely affected.

General economic and other conditions may adversely affect trends in employment and hiring patterns, which could result in lower employee participation in CDB programs, which would materially adversely affect our results of operations, financial condition, business and prospects.

Our revenue is attributable to the number of employee participants at each of our employer clients, which in turn is influenced by the employment and hiring patterns of our employer clients. To the extent our employer clients freeze or reduce their headcount or wages paid because of general economic or other conditions, demand for our programs may decrease, which could materially adversely affect our results of operations, financial condition, business and prospects.

Failure to effectively develop and expand our direct and indirect sales channels may materially adversely affect our results of operations, financial condition, business and prospects and reduce our growth.

We will need to continue to expand our sales and marketing infrastructure in order to grow our employer client base and our business. We rely on our enterprise sales force to target new Fortune 1000 client accounts and sell into the private exchanges, as well as to cross-sell additional products and services to our existing enterprise clients. Effectively training our sales personnel requires significant time, expense and attention. In addition, we utilize various channel brokers, including insurance agents, benefits

Table of Contents

consultants, regional and national insurance carriers, health plans, payroll companies, banks and regional third party administrators, to sell and market our programs to SMB employers. If we are unable to develop and expand our direct sales team, these indirect sales channels, or become a partner to more private exchanges, our ability to attract new employer clients, become a private exchange partner and cross-sell our programs may be negatively impacted and our growth opportunities will be reduced, each of which would materially adversely affect our results of operations, financial condition, business and prospects.

If our efforts to develop and expand our direct and indirect sales channels do not generate a corresponding increase in revenue, our business may be materially adversely affected. In particular, if we are unable to effectively train our sales personnel or if our direct sales personnel are unable to achieve expected productivity levels in a reasonable period of time, we may not be able to increase our revenue and grow our business.

Long sales cycles make the timing of our long-term revenues difficult to predict.

Our average sales cycle ranges from approximately two months for SMBs to six to nine months for our large institutional clients, and, in some cases, even longer depending on the size of the potential client. Factors that may influence the length of our sales cycle include:

- the need to educate potential employer clients about the uses and benefits of our CDB programs;
- the relatively long duration of the commitment clients make in their agreements with us or with pre-existing plan administrators;
- the discretionary nature of potential employer clients' purchasing and budget cycles and decisions;
- the competitive nature of potential employer clients' evaluation and purchasing processes;
- fluctuations in the CDB program needs of potential employer clients; and
- lengthy purchasing approval processes of potential employer clients.

The fluctuations that result from the length of our sales cycle may be magnified for large- and mid-sized potential employer clients. If we are unable to close an expected significant transaction with one or more of these potential clients in the anticipated period, our operating results for that period, and for any future periods in which revenue from such transaction would otherwise have been recognized, would be harmed.

Our business and operational results are subject to seasonality as a result of open enrollment for CDB programs and decreased use of commuter program offerings during typical vacation months.

The number of accounts that generate revenue is typically greatest during our first calendar quarter. This is primarily due to two factors. First, new employer clients and their employee participants typically begin service on January 1. Second, during the first calendar quarter, we are also servicing the end of plan year activity for existing clients, including assisting our clients with initiating the deduction of healthcare premiums on a tax deferred basis, and employee participants who do not continue participation into the next plan year.

Generally, in comparison to other quarters, our revenue is highest in the first quarter and lowest in the second and third quarters. Thereafter, our revenue generally grows gradually in the fourth quarter as our employer clients hire new employees who then elect to participate in our programs, thereby increasing our monthly minimum billing amount. The minimum billing amount is not, however, generally subject to downward revision when employees leave their employers because we continue to administer those former employee participants’ accounts for the remainder of the plan year. Revenue from commuter programs may vary from month-to-month because employees may elect to participate in our commuter programs at any time during the year and may change their election to participate or the amount of their contribution on a monthly basis; however, participation rates in our commuter business typically slow during the summer as people take vacations and do not purchase transit passes or parking passes during that time.

Our operating expenses increase during the fourth quarter because of increased debit card production and because we increase our customer support center capacity to answer questions from employee participants during the open enrollment periods related to their CDB participation decisions. The cost of providing services peaks in the first quarter as new employee participants contact us for information about their CDBs, and as terminating employee participants submit their final claims for reimbursement.

Our operating results can fluctuate from period to period, which could cause our share price to fluctuate.

Fluctuations in our quarterly operating results could cause our stock price to decline rapidly, may lead analysts to change their long-term models for valuing our common stock, could cause short-term liquidity issues, may impact our ability to retain or attract key

Table of Contents

personnel or cause other unanticipated issues. If our quarterly operating results or guidance fall below the expectations of research analysts or investors, the price of our common stock could decline substantially. Our quarterly operating expenses and operating results may vary significantly in the future and period-to-period comparisons of our operating results may not be meaningful. You should not rely on the results of one quarter as an indication of future performance.

If employee participants do not continue to utilize our prepaid debit cards or choose to use PIN rather than signature enabled prepaid debit cards, our results of operations, business and prospects could be materially adversely affected.

We derive a portion of our revenue from interchange fees that are paid to us when employee participants utilize our prepaid debit cards to pay for certain healthcare and commuter expenses under our CDB programs. These fees represent a percentage of the expenses transacted on each debit card. If our employer clients do not adopt these prepaid debit cards as part of the benefits programs they offer, if the employee participants do not use them at the rate we expect, if employee participants choose to process their transactions over PIN networks rather than signature networks or if other alternatives to prepaid tax-advantaged benefit cards develop, our results of operations, business and prospects could be materially adversely affected.

If we are unable to maintain and enhance our brand and reputation, our ability to sustain and grow our business may be materially adversely affected.

Maintaining and strengthening our brand is critical to attracting new clients and growing our business. Our ability to maintain and strengthen our brand and reputation will depend heavily on our capacity to continue to provide high levels of customer service to our employer clients and their employee participants at cost effective and competitive prices, which we may not do successfully. In addition, our continued success depends, in part, on our reputation as an industry leader in promoting awareness and understanding of the positive impact of CDBs among employers and employees. If we fail to successfully maintain and strengthen our brand, our results of operations, financial condition, business and prospects will be materially adversely affected.

Some plan providers with which we have relationships also provide, or may provide, competing services.

We face competitive risks in situations where some of our strategic partners are also current or potential competitors. For example, certain of the banks we utilize as custodians of the funds for our HSA employee participants also offer their own HSA products. To the extent that these partners choose to offer competing products and services that they have developed or in which they have an interest to our current or potential clients, our results of operations, business and prospects could be materially adversely affected.

We are subject to complex regulation, and any compliance failures or regulatory action could materially adversely affect our business.

The plans we administer and, as a result, our business are subject to extensive, complex and continually changing federal and state laws and regulations, including the Affordable Care Act, IRS regulations, ERISA, privacy and HIPAA regulations and Department of Labor regulations, all of which are further described in our Annual Report on Form 10-K under the heading "Business — Government Regulation". If we fail to comply with any applicable law, rule or regulation, we could be subject to fines and penalties, indemnification claims by our clients, or become the subject of a regulatory enforcement action, each of which would materially adversely affect our business and reputation.

We may also become subject to additional regulatory and compliance requirements as a result of changes in laws or regulations, or as a result of any expansion or enhancement of our existing products and services or the development of any new products or services in the future. For example, if we expand our product and service offerings into the health insurance market in the future, we would become subject to state Department of Insurance regulations. Compliance with any new regulatory requirements may divert internal resources and take significant time and effort.

Any claims of noncompliance brought against us, regardless of merit or ultimate outcome, could subject us to investigation by the Department of Labor, the Internal Revenue Service, the Centers for Medicare and Medicaid Services, the Treasury Department or other federal and state regulatory authorities, which could result in substantial costs to us and divert management's attention and other resources away from our operations. In addition, investor perceptions of us may suffer and could cause a decline in the market price of our common stock. Our compliance processes may not be sufficient to prevent assertions that we failed to comply with any applicable law, rule or regulation.

Failure to ensure and protect the confidentiality of participant data could lead to legal liability, adversely affect our reputation and have a material adverse effect on our results of operations, business or financial condition.

We must collect, store and use employee participants' confidential information, including the transmission of that data to third parties, to provide our services. For example, we collect names, addresses, social security numbers and other personally identifiable information from employee participants. In addition, we facilitate the issuance and funding of prepaid debit cards and, in some cases, collect bank routing information, account numbers and personal credit card information for purposes of funding an account or issuing a reimbursement. We have invested significantly in preserving the security of this data.

In addition, we outsource customer support center services and claims processing services to third-party subcontractors to whom we transmit certain confidential information of our employee participants. We have security measures in place with each of these subcontractors to protect this confidential information, including written agreements that outline how protected health information will be handled and shared. However, there are no assurances that these measures, or any additional security measures that our subcontractors may have in place, will be sufficient to protect this outsourced confidential information from unauthorized security breaches.

We cannot assure you that, despite the implementation of these security measures, we will not be subject to a security breach or that this data will not be compromised. We may be required to expend significant capital and other resources to protect against security breaches or to alleviate problems caused by security breaches, or to pay penalties as a result of such breaches. Despite our implementation of security measures, techniques used to obtain unauthorized access or to sabotage systems change frequently. As a result, we may be unable to anticipate these techniques or implement adequate preventative measures to protect this data. Any compromise or perceived compromise of our security could damage our reputation with our clients and brokers, and could subject us to significant liability, as well as regulatory action, including financial penalties, which would materially adversely affect our brand, results of operations, financial condition, business and prospects.

Privacy concerns could require us to modify our operations.

As part of our business, we collect employee participants' personal data for the sole purpose of processing their benefits. For privacy or security reasons, privacy groups, governmental agencies and individuals may seek to restrict or prevent our use of this data. We have incurred, and will continue to incur, expenses to comply with privacy and security standards and protocols imposed by law, regulation, industry standards or contractual obligations. Increased regulation of data utilization and distribution practices, including self-regulation, could require us to modify our operations and incur significant additional expense, which could have a material adverse effect on our results of operations, financial condition, business and prospects.

If we fail to effectively upgrade our information technology systems, our business and operations could be disrupted.

As part of our efforts to continue the improvement of our enterprise resource planning, we plan to upgrade our existing information technology systems in order to automate several controls that are currently performed manually. We may experience difficulties in transitioning to these upgraded systems, including loss of data and decreases in productivity as personnel work to become familiar with these new systems. In addition, our management information systems will require modification and refinement as we grow and as our business needs change, which could prolong difficulties we experience with systems transitions, and we may not always employ the most effective systems for our purposes. If we experience difficulties in implementing new or upgraded information systems or experience significant system failures, or if we are unable to successfully modify our management information systems or respond to changes in our business needs, we may not be able to effectively manage our business and we may fail to meet our reporting obligations.

Our future success depends on our ability to recruit and retain qualified employees, including our executive officers and directors.

Our success is substantially dependent upon the performance of our senior management, such as our chief executive officer. Our management and employees may terminate their employment at any time, and the loss of the services of any of our executive officers could materially adversely affect our business. Our success is also substantially dependent upon our ability to attract additional personnel for all areas of our organization. Competition for qualified personnel is intense, and we may not be successful in attracting and retaining such personnel on a timely basis, on competitive terms or at all. Additionally, it may be more difficult for us to attract and retain qualified individuals to serve on our board of directors or as our executive officers due to potential liability concerns related to serving on a public company. If we are unable to attract and retain the necessary personnel, our results of operations, financial condition, business and prospects would be materially adversely affected.

Table of Contents

Changes in credit card association or other network rules or standards set by Visa or MasterCard, or changes in card association and debit network fees or products or interchange rates, could materially adversely affect our results of operations, business and financial position.

We, and the banks that issue our prepaid debit cards, are subject to Visa and MasterCard association rules that could subject us to a variety of fines or penalties that may be levied by the card associations or networks for acts or omissions by us or businesses that work with us, including card processors, such as Alegius. The termination of the card association registrations held by us or any of the banks that issue our cards, or any changes in card association or other debit network rules or standards, including interpretation and implementation of existing rules, participants deciding to use PIN networks, standards or guidance that increase the cost of doing business or limit our ability to provide our products and services, or limit our ability to receive interchange, could have a material adverse effect on our results of operations, financial condition, business and prospects. In addition, from time-to-time, card associations increase the organization or processing fees that they charge, which could increase our operating expenses, reduce our profit margin and materially adversely affect our results of operations, financial condition, business and prospects.

We have entered into outsourcing and other agreements with third parties related to certain of our business operations, and any difficulties experienced in these arrangements could result in additional expense, loss of revenue or an interruption of our services.

We have entered into outsourcing agreements with third parties to provide certain customer service and related support functions to our employer clients and their employee participants. As a result, we rely on third parties over which we have limited control. If these third parties are unable to perform to our requirements or to provide the level of service required or expected by our employer clients, including ensuring the privacy and integrity of individually identifiable health information that they may be privy to as a result of the services they perform for our employer clients and their employee participants, our operating results, financial condition, business, prospects and reputation may be materially harmed. In addition, we may be forced to pursue alternative strategies to provide these services, which could result in delays, interruptions, additional expenses and loss of clients and related revenues.

If our intellectual property and technology are not adequately protected to prevent use or appropriation by our competitors, our business and competitive position could be materially adversely affected.

We rely on a combination of copyright, trademark and trade secret laws, as well as confidentiality procedures and contractual provisions, to establish and protect our intellectual property rights in the United States.

The efforts we have taken to protect our intellectual property may not be sufficient or effective, and our trademarks and copyrights may be held invalid or unenforceable. We may not be effective in policing unauthorized use of our intellectual property, and even if we do detect violations, litigation may be necessary to enforce our intellectual property rights. Any enforcement efforts we undertake, including litigation, could be time consuming and expensive, could divert our management's attention and may result in a court determining that our intellectual property rights are unenforceable. If we are not successful in cost-effectively protecting our intellectual property rights, our results of operations, financial condition, business and prospects could be materially adversely affected.

Our ability to use net operating loss carryforwards to offset future taxable income may be limited.

As of December 31, 2013, we had $54.6 million of federal and $96.4 million of state net operating loss carryforwards available to offset future taxable income. These net operating loss carryforwards will expire beginning in 2024 through 2029 for U.S. federal income tax purposes and beginning in 2015 through 2033 for state income tax purposes, if not fully utilized. In addition, we have federal and state research and development credit carryforwards of approximately $4.3 million and $2.0 million respectively. The federal research credit carryforwards expire beginning in 2022 through 2033, if not fully utilized. The California research credit carries forward indefinitely. Our ability to utilize net operating loss and tax credit carryforwards are subject to restrictions, including limitations in the event of past or future ownership changes as defined in Section 382 of the Internal Revenue Code ("IRC") of 1986, as amended, and similar state tax law. In general, an ownership change occurs if the aggregate stock ownership of certain stockholders increases by more than 50 percentage points over such stockholders' lowest percentage ownership during the testing period (generally three years). We have considered Section 382 of the IRC and concluded that any ownership change would not diminish our utilization of our net operating loss or our research and development credits during the carryover periods.

If one or more jurisdictions successfully assert that we should have collected or in the future should collect additional sales and use taxes on our fees, we could be subject to additional liability with respect to past or future sales and the results of our operations could be adversely affected.

Sales and use tax laws and rates vary by jurisdiction and such laws are subject to interpretation. In those jurisdictions where we believe sales taxes are applicable, we collect and file timely sales tax returns. Currently, such taxes are minimal. Jurisdictions in which we do not collect sales and use taxes may assert that such taxes are applicable, which could result in the assessment of such taxes, interest and penalties, and we could be required to collect such taxes in the future. This additional sales and use tax liability could adversely affect our results of operations.

Third parties may assert intellectual property infringement claims against us, or our services may infringe the intellectual property rights of third parties, which may subject us to legal liability and materially adversely affect our reputation.

Assertion of intellectual property infringement claims against us could result in litigation. We might not prevail in any such litigation or be able to obtain a license for the use of any infringed intellectual property from a third party on commercially reasonable terms, or at all. Even if obtained, we may be unable to protect such licenses from infringement or misuse, or prevent infringement claims against us in connection with our licensing efforts. Any such claims, regardless of their merit or ultimate outcome, could result in substantial cost to us, divert management’s attention and our resources away from our operations and otherwise adversely affect our reputation. Our process for controlling our own employees’ use of third-party proprietary information may not be sufficient to prevent assertions of intellectual property infringement claims against us.

We rely on insurance to mitigate some risks of our business and, to the extent the cost of insurance increases or we maintain insufficient coverage, our results of operations, business and financial condition may be materially adversely affected.

We contract for insurance to cover a portion of our potential business risks and liabilities. In the current environment, insurance companies are increasingly specific about what they will and will not insure. It is possible that we may not be able to obtain sufficient insurance to meet our needs, may have to pay very high prices for the coverage we do obtain or may not acquire any insurance for certain types of business risk including those related to cyber security matters. This could leave us exposed, and to the extent we incur liabilities and expenses for which we are not adequately insured, our results of operations, business and financial condition could be materially adversely affected.

Also, to the extent the cost of maintaining insurance increases, our operating expenses will rise, which could materially adversely affect our results of operations, financial condition, business and prospects.

We will continue to incur increased costs and demands upon management as a result of complying with the laws and regulations that affect public companies, which could materially adversely affect our results of operations, financial condition, business and prospects.

We were an “emerging growth company” until December 31, 2013, at which point we became a large accelerated filer and became subject to the requirements of Section 404 and other provisions of Sarbanes-Oxley Act of 2002, or the Sarbanes-Oxley Act, for our audited 2013 financials.

As a public company and particularly now that we have ceased to be an “emerging growth company,” we will continue to incur significant legal, accounting and other expenses that we did not incur as a private company, including costs associated with public company reporting and corporate governance requirements. These requirements include compliance with Section 404 and other provisions of the Sarbanes-Oxley Act, as well as rules implemented by the SEC and the NYSE. We expect that compliance with these rules and regulations will substantially increase our legal and financial compliance costs and will make some activities more time-consuming and costly.

We experienced an increase in legal, accounting and other professional fees in 2013 associated with preparing our control environment to be compliant with Section 404 and other provisions of the Sarbanes-Oxley Act. If these requirements divert our management’s attention from other business concerns, they could have a material adverse effect on our results of operations, financial condition, business and prospects.

Table of Contents

As a public company, we are required to maintain a system of effective control over financial reporting. In the past significant deficiencies in our internal control over financial reporting have been identified. If our internal controls are not effective, there may be errors in our financial information that could require a restatement or delay our SEC filings, and investors may lose confidence in our reported financial information, which could lead to a decline in our stock price.

We have, in the past, experienced issues with our internal control over financial reporting and it is possible that we may discover significant deficiencies or material weaknesses in our internal control over financial reporting in the future. Any failure to maintain or implement required new or improved controls, or any difficulties we encounter in their implementation, could cause us to fail to meet our periodic reporting obligations, or result in material misstatements in our financial information. Any such delays or restatements could cause investors to lose confidence in our reported financial information and lead to a decline in our stock price.

Substantial sales of our common stock by our stockholders could depress the market price of our common stock regardless of our operating results.

Sales of substantial amounts of our common stock in the public market, or the perception that these sales could occur, could adversely affect the market price of our common stock and impair our ability to raise capital through offerings of our common stock. As of June 30, 2014, we had 35,185,097 shares of our common stock outstanding. In addition, as of June 30, 2014, there were outstanding options to purchase 3,504,690 shares of our common stock and 668,061 restricted stock units. Substantially all of our outstanding common stock is eligible for sale, subject to Rule 144 volume limitations for holders affected by such limitations, as are common stock issuable under vested and exercisable options. If our existing stockholders sell a large number of common stock or the public market perceives that existing stockholders might sell our common stock, the market price of our common stock could decline significantly. These sales might also make it more difficult for us to sell equity securities at a time and price that we deem appropriate.

Our stock price has fluctuated and may continue to do so and may even decline regardless of our financial performance.

The market price of our common stock has fluctuated and may continue to fluctuate significantly in response to numerous factors, many of which are beyond our control, including:

- actual or anticipated fluctuations in our financial results;
- the financial projections we provide to the public, any changes in these projections or our failure to meet these projections;
- failure of securities analysts to initiate or maintain coverage of our company, changes in financial estimates by any securities analysts who follow our company, or our failure to meet these estimates or the expectations of investors;
- ratings changes by any securities analysts who follow our company;
- announcements by us or our competitors of significant technical innovations, acquisitions, strategic partnerships, joint ventures or capital commitments;
- changes in operating performance and stock market valuations of other newly public companies generally, or those in our industry in particular;
- changes brought about by health care reform and the emergence of federal, state and private exchanges;
- price and volume fluctuations in the overall stock market, including as a result of trends in the global economy;
- any major change in our board of directors or management;
- lawsuits threatened or filed against us; and
- other events or factors, including those resulting from war, incidents of terrorism or responses to these events.

In addition, in the past, following periods of volatility in the overall market and the market price of a particular company’s securities, securities class action litigation has often been instituted against such a company. If securities class action litigation is instituted against us, it could result in substantial costs and a diversion of our management’s attention and resources and could materially adversely affect our operating results.

Anti-takeover provisions contained in our amended and restated certificate of incorporation and amended and restated bylaws, as well as provisions of Delaware law, could impair a takeover attempt.

Our amended and restated certificate of incorporation, amended and restated bylaws and Delaware law contain provisions that could have the effect of delaying, preventing or rendering more difficult an acquisition of us if such acquisition is deemed undesirable by our board of directors. Our corporate governance documents include provisions that:

- create a classified board of directors whose members serve staggered three-year terms;

Table of Contents

- authorize “blank check” preferred stock, which could be issued by the board of directors without stockholder approval and may contain voting, liquidation, dividend and other rights superior to our common stock;
- limit the ability of our stockholders to call and bring business before special meetings;
- require advance notice of stockholder proposals for business to be conducted at meetings of our stockholders and for nominations of candidates for election to our board of directors;
- control the procedures for the conduct and scheduling of board of directors and stockholder meetings; and
- provide the board of directors with the express power to postpone previously scheduled annual meetings and to cancel previously scheduled special meetings.

These provisions, alone or together, could delay or prevent unsolicited takeovers and changes in control or changes in our management.

As a Delaware corporation, we are also subject to provisions of Delaware law, including Section 203 of the Delaware General Corporation Law, which prevents some stockholders holding more than 15% of our outstanding common stock from engaging in certain business combinations without approval of the holders of substantially all of our outstanding common stock.

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

We do not expect to declare any dividends in the foreseeable future.

We do not anticipate declaring any cash dividends to holders of our common stock in the foreseeable future. In addition, our existing credit facility prohibits us from paying cash dividends, and any future financing agreements may prohibit us from paying any type of dividends. Consequently, investors may need to rely on sales of their common stock after price appreciation, which may never occur, as the only way to realize any future gains on their investment. Investors seeking cash dividends should not purchase our common stock.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

Unregistered Sales of Equity Securities

None.

Item 6. Exhibits

The exhibits listed in the accompanying Exhibit Index are filed or incorporated by reference as part of this Quarterly Report.

Table of Contents

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

		WAGEWORKS, INC.
Date: August 4, 2014	By:	/s/ Richard T. Green
		Richard T. Green
		Chief Financial Officer
		(Principal Financial and Accounting Officer)

Table of Contents

Exhibit Index

Exhibit No.	Exhibit Description	Incorporated by Reference Form	File No.	Exhibit	Filing Date	Filed Herewith
10.1	First Amendment to Credit Agreement, dated as of July 21, 2014, by and among Registrant, the guarantors party thereto, the lenders party thereto and MUFG Union Bank, N.A. (formerly Union Bank, N.A.)					X
31.1	Certification of the Principal Executive Officer Pursuant to Exchange Act Rules 13a-14(a) and 15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002					X
31.2	Certification of the Principal Financial Officer Pursuant to Exchange Act Rules 13a-14(a) and 15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002					X
32.1(1)	Certification of the Principal Executive Officer and Principal Financial Officer Pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002					X
101.INS	XBRL Instance Document					
101.SCH	XBRL Taxonomy Schema Linkbase Document					
101.CAL	XBRL Taxonomy Calculation Linkbase Document					
101.DEF	XBRL Taxonomy Definition Linkbase Document					
101.LAB	XBRL Taxonomy Labels Linkbase Document					
101.PRE	XBRL Taxonomy Presentation Linkbase Document					

(1) The information in this exhibit is furnished and deemed not filed with the Securities and Exchange Commission for purposes of section 18 of the Exchange Act of 1934, as amended (the “Exchange Act”), and is not to be incorporated by reference into any filing of WageWorks, Inc. under the Securities Act of 1933, as amended (the “Securities Act”), or the Exchange Act, whether made before or after the date hereof, regardless of any general incorporation language in such filing.