

WAGeworks, INC.
Form 10-Q
March 18, 2019

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, 2018

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

For the transition period from _____ to _____

Commission File Number: 001-35232

WAGeworks, INC.
(Exact name of Registrant as specified in its charter)

Delaware 94-3351864
(State or other jurisdiction of (I.R.S. Employer
incorporation or organization) Identification Number)

1100 Park Place, 4th Floor
San Mateo, California 94403
(Address of principal executive offices, including 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, smaller reporting company or an emerging growth company. See the definitions of "large accelerated filer," "accelerated filer", "smaller reporting company" and "emerging growth company" in Rule 12b-2 of the Exchange Act.

Edgar Filing: WAGEWORKS, INC. - Form 10-Q

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

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

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

As of March 14, 2019, there were 39,852,857 shares of the registrant's common stock outstanding.

WAGeworks, INC.
 FORM 10-Q QUARTERLY REPORT
 Table of Contents

	Page No.
<u>PART I. FINANCIAL INFORMATION</u>	
<u>Item 1. Financial Statements (Unaudited)</u>	<u>3</u>
<u>Condensed Consolidated Balance Sheets as of June 30, 2018 and December 31, 2017</u>	<u>3</u>
<u>Condensed Consolidated Statements of Income for the Three and Six Months Ended June 30, 2018 and 2017</u>	<u>4</u>
<u>Condensed Consolidated Statements of Comprehensive Income for the Three and Six Months Ended June 30, 2018 and 2017</u>	<u>5</u>
<u>Condensed Consolidated Statements of Cash Flows for the Six Months Ended June 30, 2018 and 2017</u>	<u>6</u>
<u>Notes to Condensed Consolidated Financial Statements</u>	<u>8</u>
<u>Item 2. Management’s Discussion and Analysis of Financial Condition and Results of Operations</u>	<u>29</u>
<u>Item 3. Quantitative and Qualitative Disclosures About Market Risk</u>	<u>35</u>
<u>Item 4. Controls and Procedures</u>	<u>35</u>
<u>PART II. OTHER INFORMATION</u>	
<u>Item 1. Legal Proceedings</u>	<u>40</u>
<u>Item 1A. Risk Factors</u>	<u>40</u>
<u>Item 2. Unregistered Sales of Equity Securities and Use of Proceeds</u>	<u>40</u>
<u>Item 4. Mine Safety Disclosures</u>	<u>40</u>
<u>Item 5. Other Information</u>	<u>40</u>
<u>Item 6. Exhibits</u>	<u>41</u>
<u>Signatures</u>	<u>42</u>

Table of Contents

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

WAGWORKS, INC.

Condensed Consolidated Balance Sheets

(In thousands, except per share amounts)

	June 30, 2018	December 31, 2017
	(Unaudited)	Derived from Audited Financial Statements
Assets		
Current assets:		
Cash and cash equivalents	\$712,194	\$ 779,345
Restricted cash	332	332
Short-term investments	257,095	195,534
Receivables, net	87,137	107,547
Prepaid expenses and other current assets	23,610	29,271
Total current assets	1,080,368	1,112,029
Property and equipment, net	78,486	68,742
Goodwill	297,409	297,409
Acquired intangible assets, net	142,850	155,369
Deferred tax assets, net	8,008	10,143
Other assets	28,839	8,291
Total assets	\$1,635,960	\$ 1,651,983
Liabilities and Stockholders' Equity		
Current liabilities:		
Accounts payable and accrued expenses	\$89,047	\$ 89,977
Customer obligations	637,489	695,368
Other current liabilities	2,459	628
Total current liabilities	728,995	785,973
Long-term debt, net of financing costs	244,657	244,915
Other non-current liabilities	10,721	8,845
Total liabilities	984,373	1,039,733
Commitments and Contingencies (Note 14)		
Stockholders' Equity:		
Common stock, par value \$0.001 per share (authorized 1,000,000 shares; 40,333 shares issued and 39,853 shares outstanding at June 30, 2018 and 40,251 shares issued and 39,771 shares outstanding at December 31, 2017)	41	41
Additional paid-in capital	573,254	562,131
Treasury stock at cost (480 shares at June 30, 2018 and December 31, 2017)	(22,309)	(22,309)
Accumulated other comprehensive loss	(1,038)	(354)
Retained earnings	101,639	72,741
Total stockholders' equity	651,587	612,250
Total liabilities and stockholders' equity	\$1,635,960	\$ 1,651,983

See accompanying notes to the condensed consolidated financial statements.

Table of Contents

WAGEWORKS, INC.

Condensed Consolidated Statements of Income

(In thousands, except per share amounts)

(Unaudited)

	Three Months Ended June 30,		Six months ended June 30,	
	2018	2017	2018	2017
Revenues:				
Healthcare	\$68,104	\$68,202	\$143,361	\$142,876
COBRA	26,200	27,018	55,035	55,568
Commuter	18,847	17,836	37,725	36,379
Other	3,357	4,076	7,028	8,346
Total revenues	116,508	117,132	243,149	243,169
Operating expenses:				
Cost of revenues (excluding amortization of internal use software)	36,143	43,319	81,386	91,407
Technology and development	13,392	14,515	26,425	29,786
Sales and marketing	18,521	14,728	36,859	30,807
General and administrative	18,898	18,459	44,147	31,959
Amortization	10,191	9,393	20,182	18,630
Employee termination and other charges	2,853	917	2,853	1,648
Total operating expenses	99,998	101,331	211,852	204,237
Income from operations	16,510	15,801	31,297	38,932
Other income (expense):				
Interest income	1,432	95	2,703	162
Interest expense	(2,420)	(1,766)	(4,602)	(3,202)
Other income (expense), net	23	(9)	18	(230)
Income before income taxes	15,545	14,121	29,416	35,662
Income tax (provision) benefit	(4,621)	6,157	(7,473)	673
Net income	\$10,924	\$20,278	\$21,943	\$36,335
Net income per share:				
Basic	\$0.27	\$0.54	\$0.55	\$0.98
Diluted	\$0.27	\$0.53	\$0.54	\$0.94
Shares used in computing net income per share:				
Basic	39,853	37,419	39,838	37,209
Diluted	40,412	38,613	40,446	38,514

See accompanying notes to the condensed consolidated financial statements.

Table of Contents

WAGEWORKS, INC.

Condensed Consolidated Statements of Comprehensive Income

(In thousands)

(Unaudited)

	Three Months		Six months ended	
	Ended June 30,		June 30,	
	2018	2017	2018	2017
Net income	\$10,924	\$20,278	\$21,943	\$36,335
Other comprehensive income (loss), net of tax:				
Net unrealized gain (loss) on short-term investments, net of tax	46	—	(686)	—
Other comprehensive income (loss), net of tax	46	—	(686)	—
Total comprehensive income	\$10,970	\$20,278	\$21,257	\$36,335

See accompanying notes to the condensed consolidated financial statements.

Table of Contents

WAGEWORKS, INC.

Condensed Consolidated Statements of Cash Flows

(In thousands)

(Unaudited)

	Six Months Ended June 30,	
	2018	2017
Cash flows from operating activities:		
Net income	\$21,943	\$36,335
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Depreciation	6,651	5,221
Amortization	20,183	18,630
Amortization of debt issuance costs	242	125
Accrued interest on debt securities	(413))
Amortization of commissions	(1,576))
Stock-based compensation expense	8,881	10,812
Loss on disposal of fixed assets	34	91
(Recoveries from) provision for doubtful accounts	98	(141)
Deferred taxes	—	593
Changes in operating assets and liabilities:		
Receivables	20,312	(56,269)
Prepaid expenses and other current assets	10,116	(12,073)
Other assets	(14,109)	) 809
Accounts payable and accrued expenses	(1,772)	) 27,792
Customer obligations	(57,879)	) (42,466)
Other liabilities	848	2,242
Net cash provided by (used in) operating activities	13,559	(8,299)
Cash flows from investing activities:		
Purchases of property and equipment	(19,834)	) (17,534)
Purchases of investments	(122,823))
Proceeds from sales of investments	4,096	—
Proceeds from maturities of investments	56,665	—
Purchases of intangible assets	(209)	) (397)
Net cash used in investing activities	(82,105)	) (17,931)
Cash flows from financing activities:		
Proceeds from public stock offering, net of underwriting discounts, commissions and other costs	—	131,177
Proceeds from exercise of common stock options	1,396	10,002
Proceeds from issuance of common stock under Employee Stock Purchase Plan	869	1,511
Payments of debt issuance costs	(500)	) (1,852)
Payments of debt principal	—	) (2,500)
Payment of shares withheld related to restricted stock units	(218))
Payment of capital lease obligations	(152)	) (147)
Taxes paid related to net share settlement of stock-based compensation arrangements	—	) (8,437)
Net cash provided by financing activities	1,395	129,754
Net (decrease) increase in cash and cash equivalents, unrestricted and restricted	(67,151)	) 103,524
Cash and cash equivalents at beginning of period, unrestricted and restricted	779,677	672,941
Cash and cash equivalents, unrestricted and restricted, at end of period	\$712,526	\$776,465
Supplemental cash flow disclosure:		

Edgar Filing: WAGEWORKS, INC. - Form 10-Q

Cash paid during the period for:		
Interest	\$4,139	\$2,808
Income taxes	\$1,979	\$2,743
Noncash financing and investing activities:		
Property and equipment, accrued but not paid	\$3,168	\$1,922
Public stock offering costs, accrued but not paid	\$—	\$402
Property and equipment financed under capital lease	\$142	\$263

Table of Contents

See accompanying notes to the condensed consolidated financial statements.

7

Table of Contents

Notes to Condensed Consolidated Financial Statements (Unaudited)

Note 1 Summary of Business and Significant Accounting Policies

Business

WageWorks, Inc., (together with its subsidiaries, “WageWorks” or the “Company”) was incorporated in the state of Delaware in 2000. The Company is a leader in administering Consumer-Directed Benefits (“CDBs”), which empower employees to save money on taxes while also providing corporate tax advantages for employers.

The Company operates as a single reportable segment on an entity level basis and considers itself to operate under one operating and reporting segment with healthcare, transit and other employer sponsored programs representing a group of similar products lines. The Company believes that it engages in a single business activity and operates in a single economic environment.

Basis of Presentation

The unaudited interim condensed consolidated financial statements and the related 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 (“U.S. 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, 2018.

These unaudited interim condensed consolidated financial statements and the related notes should be read in conjunction with the December 31, 2017 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, 2017 consolidated balance sheet, included in this interim Quarterly Report on Form 10-Q, was derived from audited financial statements. Certain prior year amounts in the condensed consolidated statements of cash flows have been reclassified to conform to the current year’s presentation.

Other than the adoption of ASU 2014-09, "Revenue from Contracts with Customers (Topic 606)" and ASU 2016-18, Statement of Cash Flows (Topic 230): Restricted Cash, there have been no material changes to our critical accounting policies and estimates during the three months ended June 30, 2018, as compared to the critical accounting policies and estimates disclosed in the “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, 2017.

Principles of Consolidation

The unaudited condensed consolidated financial statements include the accounts of WageWorks, Inc. and its subsidiaries. All significant intercompany accounts and transactions have been eliminated in consolidation.

Revenue Recognition

On January 1, 2018, we adopted the requirements of Accounting Standards Update (“ASU”) No. 2014-09, Revenue from Contracts with Customers (Topic 606) (“ASC 606”) as discussed further in Recently Adopted Accounting Pronouncements below. ASC 606 establishes a principle 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. ASC 606 also includes Subtopic 340-40, Other Assets and Deferred Costs-Contracts with Customers, which requires the deferral of incremental costs of obtaining a contract with a customer. Collectively, references to ASC 606 used herein refer to both ASC 606 and Subtopic 340-40.

We account for revenue contracts with customers by applying the requirements of ASC 606, which includes the following steps:

- 1 Identification of the contract, or contracts, with the customer;
- 2 Identification of the performance obligations in the contract;
- 3 Determination of the transaction price;
- 4 Allocation of the transaction price to the performance obligations in the contract; and
- 5 Recognition of the revenue when, or as, the Company satisfies a performance obligation.

Table of Contents

Notes to Condensed Consolidated Financial Statements (continued)
(Unaudited)

Our revenues are derived primarily from benefit service administration, interchange and other commissions and other revenue which includes services related to enrollment and eligibility, non-healthcare, and employee account administration (i.e., tuition and health club reimbursements) and project-related professional services. We account for individual products and services separately if they are distinct—that is, if a product or service is separately identifiable from other items in the contract and if a customer can benefit from it on its own or with other resources that are readily available to the customer.

We account for a contract with a customer when there is approval and commitment from both parties, the rights of the parties are identified, payment terms are identified, the contract has commercial substance and collectability of consideration is probable. We measure revenue based on the consideration specified in the contract with each customer, net of any sales incentives and taxes collected on behalf of government authorities. We recognize revenue in a manner that best depicts the transfer of promised goods or services to the customer, when control of the product or service is transferred to a customer. We make significant judgments when determining the appropriate timing of revenue recognition.

Based upon similar operational and economic characteristics, the Company's revenues are disaggregated into Healthcare, Commuter, COBRA and Other revenue. The Company believes these revenue categories depict how the nature, amount, timing, and uncertainty of its revenue and cash flows are affected by economic factors.

Healthcare and commuter programs include revenues generated from the monthly administration services based on employee participant levels and interchange and other commission revenues.

COBRA revenue is generated from the administration of continuation of coverage services for participants who are no longer eligible for the employer's health benefits, such as medical, dental, vision and for the continued administration of employee participants' Health Reimbursement Arrangements ("HRAs"), and certain healthcare Flexible Spending Accounts ("FSAs").

Other revenue includes services related to enrollment and eligibility, non-healthcare, employee account administration (i.e., tuition and health club reimbursements).

Within our Healthcare and Commuter service lines, we have determined that our administration services are a single continuous service. These services are consumed as they are received and the Company recognizes service revenue over time on a monthly basis as it satisfies its performance obligations. As such, the Company recognizes revenue in each month for the administration services provided in that month using the variable consideration allocation exception. The Company applies this exception because it concluded that the nature of its obligations and the variable payment terms are aligned and the uncertainty related to the consideration is resolved on a monthly basis as the Company satisfies its obligations. The administration services are typically billed in the period in which services are performed.

COBRA requires employers to make health coverage available for terminated employees for a period of up to 36 months post-termination. Similar to our Healthcare and Commuter service lines, our COBRA administration services are a single continuous service. These services are consumed as they are received and the Company recognizes service revenue over time on a monthly basis as it satisfies its performance obligations. As such, the Company recognizes revenue in each month for the COBRA administration services provided in that month using either the as-invoiced practical expedient or the variable consideration allocation exception. The administration services are typically billed in the period in which services are performed.

We also recognize revenues that are generated from the use of debit cards used by employee participants related to the distribution, management and monitoring of such cards and used in connection with our benefits administration services for Healthcare and Commuter service lines. These related fees are known as interchange fees and are based upon a percentage of the amounts transacted on each card. We have determined that our performance obligation for interchange is a single continuous service, which is satisfied over time each month. Therefore, we recognize interchange revenue on a monthly basis based on the services provided and use the variable consideration allocation exception. The interchange revenues are typically billed in the period in which services are performed.

Contract Assets Contract assets include amounts related to our enforceable right to consideration for completed performance obligations not yet invoiced. The contract assets are transferred to the receivables balance when the rights become unconditional.

Contract Liabilities Contract liabilities are recorded as deferred revenues and include payments received in advance of performance under the contract. We generally invoice our customers for services as they are provided on a monthly basis, however in limited instances we may invoice in advance of services to be provided. Contract liabilities are recognized as revenue when

Table of Contents

Notes to Condensed Consolidated Financial Statements (continued)
(Unaudited)

the services are provided to the customer. Contract liabilities that are anticipated to be recognized during the succeeding twelve-month period are recorded as current deferred revenue and the remaining portion is recorded as noncurrent.

Contract Costs ASC 606 requires the recognition of an asset for the incremental costs of obtaining a contract with a customer if the entity expects to recover such costs. Incremental costs are costs that would not have been incurred if the contract had not been obtained. Examples of contract costs are commissions paid to sales personnel. Sales commissions earned by the Company's sales force are considered incremental and recoverable costs of obtaining a contract with a customer. Sales commissions for initial contracts are deferred and then amortized on a straight-line basis over a period of benefit that has been determined to be six years. The Company determined the period of benefit by taking into consideration length of customer contracts, useful life of developed technology, regulatory oversight the Company is subject to, and other factors. Amortization expense is included in Sales and marketing expenses on the condensed consolidated statements of income.

Use of Estimates

In preparing the Consolidated Financial Statements and related disclosure in conformity with United States ("U.S.") generally accepted accounting principles ("GAAP"), including all adjustments as a result of the Company's restatement, and pursuant to the rules and regulations of the Securities and Exchange Commission ("SEC"), the Company must make estimates and judgments that affect the amounts reported in the Consolidated Financial Statements and accompanying notes. Estimates are used for, but not limited to revenue recognition, allocation of purchase consideration to acquired assets and liabilities from business combinations, allowances for doubtful accounts, useful lives for depreciation and amortization, loss contingencies, income taxes, the assumptions used for stock-based compensation including attainment of performance-based awards, the assumptions used for software and web site development cost classification, and recoverability and impairments of goodwill and long-lived assets and average customer life. Actual results may be materially different from those estimates. In making its estimates, the Company considers the current economic and legislative environment.

Cash, Cash Equivalents, and Restricted Cash

The Company considers all highly liquid investments with an original maturity of 90 days or less to be cash equivalents. Cash and cash equivalents consist of cash on deposit with banks and money market funds, stated at cost, as well as commercial paper with an original maturity of less than 90 days as further described under Marketable Securities below. To the extent the Company's contracts do not provide for any restrictions on the Company's use of cash that it receives from clients, the cash is recorded as cash and cash equivalents.

The majority of the Company's cash and cash equivalents represent funding and pre-funding balances received from customers for which the Company has a corresponding current obligation. In all cases where we have collected cash from a customer but not fulfilled services (the payment of participant healthcare claims and commuter benefits), the Company recognizes a related liability to its customers, classified as customer obligations in the accompanying consolidated balance sheets.

Restricted cash represents cash used to collateralize standby letters of credit which were issued to the benefit of a third party to secure a contract with the Company.

Edgar Filing: WAGEWORKS, INC. - Form 10-Q

The following table summarizes the Company's cash and cash equivalents as at June 30, 2018 and December 31, 2017 (in thousands):

	June 30, 2018	December 31, 2017
Cash and cash equivalents, unrestricted	\$712,194	\$ 779,345
Cash and cash equivalents, restricted	332	332
Total unrestricted and restricted cash and cash equivalents	\$712,526	\$ 779,677

Marketable Securities

The Company determines the classification of its investments in marketable securities at the time of purchase and accounts for them as available-for-sale. Marketable securities of highly liquid investments with stated maturities of three months or less when purchased are classified as cash equivalents and those with stated maturities of between three months and one year as short-

Table of Contents

Notes to Condensed Consolidated Financial Statements (continued) (Unaudited)

term investments. Marketable securities with maturities beyond twelve months are also included in short-term investments within current assets as the Company intends for its investments to support current operations and other strategic initiatives. These securities are reported at fair value, which includes the accrued interest of interest-bearing securities. Unrealized gains and losses, net of taxes, are included in accumulated other comprehensive loss as a component of stockholders' equity, except for unrealized losses determined to be other-than-temporary which will be recorded within other income (expense). Realized gains and losses on the sale of marketable securities are recorded in other income (expense).

Receivables

Receivables represent both trade receivables from customers in relation to fees for the Company's services and unpaid amounts for benefit services provided by third-party vendors, such as transit agencies and healthcare providers for which the Company records a receivable for funding and a corresponding customer obligations liability until the Company disburses the balances to the vendors. The Company provides for an allowance for doubtful accounts by specifically identifying accounts with a risk of collectability and providing an estimate of the loss exposure. The Company reviews its allowance for doubtful accounts on a quarterly basis. Account balances are written off against the allowance after all means of collection have been exhausted and the potential for recovery is considered remote. Write-offs for the six months ended June 30, 2018 and 2017 were not significant.

The Company offsets on a customer by customer basis unpaid amounts for benefit services and customer obligation balances for financial reporting presentation. Additionally, the Company offsets outstanding trade and non-trade receivables, including any debit or credit memos, against any prefund balances after plan year close or upon termination of services both based on the completion of a full reconciliation with the customer.

Property and Equipment

Property and equipment are stated at cost less accumulated depreciation and amortization. Depreciation on computer and equipment and furniture and fixtures is calculated on a straight-line basis over the estimated useful lives of those assets, ranging from three to five years. Leasehold improvements are amortized on a straight-line basis over the shorter of their estimated useful life or the lease term. When events or circumstances suggest an asset's life is different than initially estimated, management reassesses the useful life of the asset and recognizes future depreciation prospectively over the revised life.

When assets are retired or otherwise disposed of, the cost and related accumulated depreciation / amortization are removed from their respective accounts, and any gain or loss on such sale or disposal is reflected in operating expenses.

Maintenance and repairs are expensed as incurred. Expenditures that substantially increase an asset's useful life are capitalized.

Software and Web Site Development Costs

Costs incurred to develop software for internal use are capitalized and amortized over the technology's estimated useful life, generally four years. When events or circumstances suggest an asset's life is different than initially estimated, management reassesses the useful life of the asset and recognizes future amortization prospectively over the

revised life. Costs incurred related to the planning and post implementation phases of development are expensed as incurred. Costs associated with the platform content or the repair or maintenance, including transfer of data between existing platforms are expensed as incurred.

Fair Value of Financial Instruments

Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. In determining fair value, we utilize valuation techniques that maximize the use of observable inputs and minimize the use of unobservable inputs to the extent possible and we consider counterparty credit risk in our assessment of fair value. Carrying amounts of financial instruments, including cash equivalents, accounts receivable, accounts payable, and accrued liabilities, approximate their fair values as of the balance sheet dates because of their short maturities. The carrying value of the Company's debt under the credit facility is estimated to approximate fair value as the interest rate approximates the market rate for debt securities with similar terms and risk characteristics. The determination of the fair value of the Company's marketable securities is further explained in Note 5 Investments and Fair Value Measurements.

Table of Contents

Notes to Condensed Consolidated Financial Statements (continued) (Unaudited)

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.

Impairment of Long-lived Assets

The Company reviews long-lived assets for indicators of impairment whenever events or changes in circumstances indicate that the carrying amounts of such assets may not be recoverable. An impairment of long-lived assets exists when the carrying amount of a long-lived asset group, exceeds its fair value. Such impairment arises in circumstances when such assets are assessed and determined to have no continuing or future benefit. Impairment losses are recorded when the carrying amount of the impaired asset group is not recoverable. Recoverability is determined by comparing the carrying amount of the asset or asset group to the undiscounted cash flows which are expected to be generated from its use. If the carrying amount of the asset group exceeds its estimated future cash flows, an impairment charge is recognized by the amount by which the carrying amount of the asset or asset group exceeds its fair value.

Acquisitions, Goodwill and Definite lived Intangible Assets

The cost of an acquisition is allocated to the tangible assets and definite lived intangible assets acquired and liabilities assumed based on their fair value at the date of acquisition. Goodwill represents the excess cost over the fair value of net assets acquired in the acquisition and is not amortized, but rather is tested for impairment.

Definite lived intangible assets, consisting of client/broker contracts and relationships, trade names, technology, noncompete agreements and favorable lease arrangements, are stated at cost less accumulated amortization. All definite lived intangible assets are amortized on a straight-line basis over their estimated remaining economic lives, generally ranging from one to ten. Amortization expense related to these intangible assets is included in amortization expense on the consolidated statements of income.

The Company performs a goodwill impairment test annually on December 31st and more frequently if events and circumstances indicate that the asset might be impaired. The following are examples of triggering events that could indicate that the fair value of a reporting unit has fallen below the unit's carrying amount:

- A significant adverse change in legal factors or in the business climate
- An adverse action or assessment by a regulator
- Unanticipated competition
- A loss of key personnel
-

A more likely than not expectation that a reporting unit or a significant portion of a reporting unit will be sold or otherwise disposed of

An impairment loss is recognized to the extent that the carrying amount exceeds the reporting unit's fair value. When reviewing goodwill for impairment, the Company assesses whether goodwill should be allocated to operating levels lower than the Company's single operating segment for which discrete financial information is available and reviewed for decision-making purposes. These lower levels are referred to as reporting units. The Company's chief operating decision maker, the Chief Executive Officer, does

12

Table of Contents

Notes to Condensed Consolidated Financial Statements (continued) (Unaudited)

not allocate resources or assess performance at the individual healthcare, commuter, COBRA or other revenue stream level, but rather at the operating segment level. Discrete financial information is therefore not maintained at the revenue stream level. The Company's one reporting unit was determined to be the Company's one operating segment.

Whenever events or circumstances change, entities have the option to first make a qualitative evaluation about the likelihood of goodwill impairment. In assessing the qualitative factors, the Company assesses relevant events and circumstances that may impact the fair value and the carrying amount of the reporting unit. The identification of relevant events and circumstances and how these may impact a reporting unit's fair value or carrying amount involve significant judgments and assumptions. The judgment and assumptions include the identification of macroeconomic conditions, industry and market considerations, overall financial performance, Company specific events and share price trends and making the assessment on whether each relevant factor will impact the impairment test positively or negatively and the magnitude of any such impact.

The goodwill impairment analysis is a two-step process: first, the reporting unit's estimated fair value is compared to its carrying value, including goodwill. If the Company determines that the estimated fair value of the reporting unit is less than its carrying value, the Company moves to the second step to determine the implied fair value of the reporting unit's goodwill. If the carrying amount of the reporting unit's goodwill exceeds its implied fair value, an impairment loss is recognized for any excess of the carrying amount of the reporting unit's goodwill over the implied fair value of the reporting unit in a manner similar to a purchase price allocation. If impairment is deemed more likely than not, management would perform the two-step goodwill impairment test. Otherwise, the two-step goodwill impairment test is not required.

Income Taxes

The Company reports income taxes using an asset and liability approach. Deferred tax assets and liabilities arise from the differences between the tax basis of an asset or liability and its reported amount in the consolidated financial statements, as well as from net operating loss and tax credit carryforwards. Deferred tax amounts are determined by using the tax rates expected to be in effect when the taxes will actually be paid or refunds received, as provided under current enacted tax law. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date. A valuation allowance reduces the deferred tax assets to the amount that is more likely than not to be realized.

The Company records a valuation allowance to reduce the deferred tax assets to the amount that the Company believes is more likely than not to be realized based on its judgment of all available positive and negative evidence. The weight given to the potential effect of negative and positive evidence is commensurate with the extent to which the strength of the evidence can be objectively verified. This assessment, which is completed on a taxing jurisdiction basis, takes into account a number of types of evidence, including the following:

- The nature and history of current or cumulative financial reporting income or losses;
- Sources of future taxable income;
- The anticipated reversal or expiration dates of the deferred tax assets; and
- Tax planning strategies.

The Company takes a two-step approach to recognizing and measuring the financial statement benefit of uncertain tax positions. The first step is to evaluate the tax position for recognition by determining whether the weight of available evidence indicates that it is more likely than not that the tax position will be sustained on audit, including resolution of

any related appeals or litigation processes. The second step is to measure the tax benefit as the largest amount that is more than 50% likely of being realized upon settlement of the audit. The Company classifies interest and penalties on unrecognized tax benefits as income tax expense or benefit.

Customer Obligation Liability

Many of our customer agreements include provisions whereby our customers remit funds to us which represent prefunds of employer / client and employee participant contributions related to FSA, HRA and commuter programs. The agreements do not represent restricted cash and accordingly the amounts received are included in cash and cash equivalents on our consolidated balance sheets with a corresponding liability recorded as customer obligations. Our customers generally provide us with prefunds

Table of Contents

Notes to Condensed Consolidated Financial Statements (continued)
(Unaudited)

for their FSA and HRA programs based on a percentage of projected spending by the employee participants for the plan year and other factors. 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 maintained throughout the year by our FSA, HRA and commuter clients as benefits are provided under these programs.

The Company offsets on a customer by customer basis non-trade accounts receivable and customer obligation balances for financial reporting presentation. Additionally, the Company offsets outstanding trade and non-trade receivables, including any debit or credit memos, against any prefund balances after plan year close or upon termination of services both based on the completion of a full reconciliation with the customer.

Recent Accounting Pronouncements

Recently Adopted Accounting Guidance

In May 2014, the Financial Accounting Standards Board ("FASB") issued ASU No. 2014-09, "Revenue from Contracts with Customers (Topic 606)" ("ASC 606"), amending revenue recognition guidance and requiring more detailed disclosures to enable users of financial statements to understand the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers is effective for annual and interim reporting periods beginning after December 15, 2017, with early adoption permitted for public companies effective for annual and interim reporting periods beginning after December 15, 2016. We adopted ASC 606 on January 1, 2018 by applying the modified retrospective approach to all contracts that were not completed as of January 1, 2018. Results for the reporting period beginning January 1, 2018 are presented under ASC 606, while prior periods are not adjusted and continue to be reported under the accounting standards in effect for the prior period. We recorded an increase in total assets of \$9.3 million and an increase in retained earnings of \$6.9 million (net of tax effect) as of January 1, 2018 attributed to the deferral of commission cost. The tax impact resulted in an increase in deferred tax liabilities in the amount of \$2.4 million with an offset to retained earnings upon adoption. See Note 3 Revenue for more details.

In November 2016, the FASB issued ASU 2016-18, Statement of Cash Flows (Topic 230): Restricted Cash. ASU No. 2016-18 addresses diversity in practice from entities classifying and presenting transfers between cash and restricted cash as operating, investing or financing activities or as a combination of those activities in the statement of cash flows. The ASU requires entities to show the changes in the total of cash, cash equivalents, restricted cash and restricted cash equivalents in the Statement of Cash Flows. As a result, transfers between such categories are no longer be presented in the Statement of Cash Flows. The Company adopted this standard on January 1, 2018 using the retrospective method. This amendment did not have a material impact on the Company's condensed consolidated statements of income, balance sheet or cash flows.

In January 2016, the FASB issued ASU No. 2016-01, "Financial Instruments-Overall: Recognition and Measurement of Financial Assets and Financial Liabilities." This guidance principally affects accounting standards for equity investments, financial liabilities where the fair value option has been elected, and the presentation and disclosure requirements for financial instruments. Upon the effective date of the new guidance, all equity investments in unconsolidated entities, other than those accounted for using the equity method of accounting, will generally be measured at fair value through earnings. There will no longer be an available-for-sale classification and therefore, no changes in fair value will be reported in other comprehensive income (loss) for equity securities with readily determinable fair values. The Company adopted this standard on January 1, 2018. This amendment did not have a material impact on the Company's condensed consolidated statements of income, balance sheet or cash flows.

In March 2016, the FASB issued Accounting Standard Update No. 2016-04, Recognition of Breakage for Certain Prepaid Stored-Value Products (“ASU 2016-04”). The new guidance creates an exception under ASC 405-20, Liabilities-Extinguishments of Liabilities, to derecognize financial liabilities related to certain prepaid stored-value products using a revenue-like breakage model. The Company adopted this update on January 1, 2018. This amendment did not have a material impact on the Company's condensed consolidated statements of income, balance sheet or cash flows.

In August 2016, the FASB issued ASU No. 2016-15, Statement of Cash flows: Classification of Certain Cash Receipts and Cash Payments. The update provides specific guidance on a number of cash flow classification issues including contingent consideration payments made after a business combination, proceeds from settlement of insurance claims, proceeds from settlement of corporate-owned life insurance policies, including bank-owned life insurance policies, distributions received from equity method investees and separately identifiable cash flows and application of the predominance principle. The Company adopted this update on January 1, 2018. This amendment did not have a material impact on the Company's condensed consolidated statements of income, balance sheet or cash flows.

Table of Contents

Notes to Condensed Consolidated Financial Statements (continued)
(Unaudited)

In May 2017, the FASB issued ASU No. 2017-09, Compensation-Stock Compensation: Scope of Modification Accounting ("ASU 2017-09"). The update amends the scope of modification accounting for shared-based payment arrangements to specify that modification accounting would not be applicable if the fair value, vesting conditions and classification of the shared-based awards are the same immediately before and after the modification. The Company adopted this update on January 1, 2018. This update did not have a material impact on the Company's condensed consolidated statements of income, balance sheet or cash flows.

Recently Issued Accounting Pronouncements

In February 2016, the FASB, issued ASU No. 2016-02, Leases (Topic 842), which requires lessees to apply a dual approach, classifying leases as either finance or operating leases based on the principle of whether or not the lease is effectively a financed purchase by the lessee. This classification will determine whether lease expense is recognized based on an effective interest method or on a straight-line basis over the term of the lease. A lessee is also required to record a right-of-use asset and a lease liability for all leases with a term of greater than 12 months regardless of their classification. Leases with a term of 12 months or less will be accounted for similar to existing guidance for operating leases.

The Company will adopt the standard effective in the first quarter of 2019 and will not restate comparative periods upon adoption. The Company will elect a package of practical expedients for leases that commenced prior to January 1, 2019 and will not reassess: (i) whether any expired or existing contracts are or contain leases; (ii) lease classification for any expired or existing leases; and (iii) initial direct costs capitalization for any existing leases. The Company will make an accounting policy election to keep leases with an initial term of 12 months or less off of the balance sheet. The Company will recognize those lease payments in the consolidated statements of income on a straight-line basis over the lease term.

The Company currently expects that our operating lease commitments will be subject to the new standard and recognized as operating lease liabilities and right-of-use assets upon its adoption of Topic 842, which will increase the total assets and total liabilities that were reported relative to such amounts prior to adoption. Refer to Note 14 for further information on operating lease commitments. The Company plans to adopt Topic 842 using the alternative modified retrospective approach with the cumulative effect of adoption recognized to retained earnings on January 1, 2019. The Company does not believe the new standard will have a material impact on the consolidated statements of income, nor will it have a notable impact on liquidity. The standard will also have no material impact on debt-covenant compliance under our current agreements.

In June 2016, the FASB issued ASU No. 2016-13, "Financial Instruments - Credit Losses: Measurement of Credit Losses on Financial Instruments (Topic 360)", which amends the FASB's guidance on the impairment of financial instruments. The ASU adds to GAAP an impairment model (known as the "current expected credit loss model") that is based on expected losses rather than incurred losses. ASU 2016-13 is effective for annual reporting periods ending after December 15, 2019, including interim periods within those fiscal years. Early adoption is permitted for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. The Company is currently evaluating the timing and impact of adoption on the Company's consolidated financial statements.

In January 2017, the FASB issued ASU No. 2017-04, "Intangibles - Goodwill and Other (Topic 350): Simplifying the Test for Goodwill Impairment." The amendments eliminate Step 2 from the goodwill impairment test. The annual, or interim, goodwill impairment test is performed by comparing the fair value of a reporting unit with its carrying amount. An impairment charge should be recognized for the amount by which the carrying amount exceeds the

reporting unit's fair value; however, the loss recognized should not exceed the total amount of goodwill allocated to that reporting unit. In addition, income tax effects from any tax deductible goodwill on the carrying amount of the reporting unit should be considered when measuring the goodwill impairment loss, if applicable. The amendments also eliminate the requirements for any reporting unit with a zero or negative carrying amount to perform a qualitative assessment and, if it fails that qualitative test, to perform Step 2 of the goodwill impairment test. An entity still has the option to perform the qualitative assessment for a reporting unit to determine if the quantitative impairment test is necessary. The new standard is expected to be effective for fiscal years beginning after December 15, 2019, with early adoption permitted. The Company is currently evaluating the timing of adoption; however, it does not believe this ASU will have a material impact on the Company's consolidated financial statements.

In February 2018, the FASB issued ASU No. 2018-02, "Income Statement - Reporting Comprehensive Income (Topic 220) - Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income". This standard allows a reclassification from accumulated other comprehensive income to retained earnings for stranded tax effects resulting from the Tax Cuts and Jobs Act and requires certain disclosures about stranded tax effects and will be effective for the Company beginning January 1, 2019

Table of ContentsNotes to Condensed Consolidated Financial Statements (continued)
(Unaudited)

and should be applied either in the period of adoption or retrospectively. Early adoption is permitted. The Company is currently evaluating the timing of adoption; however, it does not believe this ASU will have a material impact on the Company's consolidated financial statements.

In August 2018, the FASB issued ASU No. 2018-13, "Fair Value Measurement (Topic 820): Disclosure Framework-Changes to the Disclosure Requirements for Fair Value Measurement." The primary focus of ASU 2018-13 is to improve the effectiveness of the disclosure requirements for fair value measurements. The changes affect all companies that are required to include fair value measurement disclosures. In general, the amendments in this standard are effective for all entities for fiscal years and interim periods within those fiscal years, beginning after December 15, 2019. Early adoption is permitted. The Company is currently evaluating the timing of adoption; however, it does not believe this ASU will have a material impact on the Company's consolidated financial statements.

In November 2018, the FASB issued ASU No. 2018-19, "Codification Improvements to Topic 326, Financial Instruments-Credit Losses." ASU 2018-19 clarifies that receivables arising from operating leases are not within the scope of the credit losses standard, but rather, should be accounted for in accordance with the leases standard. In general, the amendments in this standard are effective for public business entities that meet the definition of a SEC filer for fiscal years beginning after December 15, 2019, and interim periods within those fiscal years. The Company is currently evaluating the timing and impact of adoption.

Note 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,	
	2018	2017	2018	2017
Numerator for basic net income per share:				
Net income	\$ 10,924	\$ 20,278	\$ 21,943	\$ 36,335
Denominator for basic net income per share:				
Weighted-average common shares outstanding	39,853	37,419	39,838	37,209
Basic net income per share	\$0.27	\$0.54	\$0.55	\$0.98
Numerator for diluted net income per share:				
Net income	\$ 10,924	\$ 20,278	\$ 21,943	\$ 36,335
Denominator for diluted net income per share:				
Weighted-average common shares outstanding	39,853	37,419	39,838	37,209
Dilutive stock options, restricted stock and performance restricted stock units and employee stock purchase plan shares	559	1,194	608	1,305
Diluted weighted-average common shares outstanding	40,412	38,613	40,446	38,514
Diluted net income per share	\$0.27	\$0.53	\$0.54	\$0.94

Stock options and restricted stock units to purchase common stock are not included in the computation of diluted earnings per share if their effect would be anti-dilutive. The Company excluded 1.8 million and 0.7 million anti-dilutive share equivalents in the calculation of diluted earnings per share for the three months ended June 30, 2018 and 2017, respectively; and 1.6 million and 0.6 million anti-dilutive shares for the six months ended June 30, 2018 and 2017, respectively.

Note 3 Revenue

On January 1, 2018, we adopted ASC 606, applying the modified retrospective method to all contracts that were not completed as of that date. Results for reporting periods beginning after January 1, 2018 are presented under ASC 606, while

16

Table of ContentsNotes to Condensed Consolidated Financial Statements (continued)
(Unaudited)

prior period results are not adjusted and continue to be reported in accordance with Topic 605, Revenue Recognition. See the Company's Annual Report on Form 10-K for the year ended December 31, 2017 for our accounting policies applied to revenue recognition prior to adoption of ASC 606. We generally invoice our customers at the beginning of the term on a monthly basis with a term of net 30-60 days. We applied the practical expedient provided by ASC 606 and did not evaluate contracts of one year or less for the existence of a significant financing component. Our policy is to exclude sales and other indirect taxes when measuring the transaction price of its subscription agreements. The primary impact of adopting ASC 606 relates to the deferral of incremental costs of obtaining customer contracts and the amortization of those costs over the period of benefit. We recorded an increase in total assets of \$9.3 million and an increase in retained earnings of \$6.9 million (net of tax effect) as of January 1, 2018. The tax impact resulted in an increase in deferred tax liabilities in the amount of \$2.4 million with an offset to retained earnings upon adoption. The adoption of the preceding standard did not have a material impact on the Company's revenue for the three and six months ended June 30, 2018.

Disaggregation of Revenue

The Company's primary categories of revenue are Healthcare, Commuter, COBRA and Other revenue and are disclosed in the condensed consolidated statements of income. The following table provides information about disaggregated revenue from contracts with customers by the nature of the products and services (in thousands):

	Three Months		Six Months Ended	
	Ended June 30		June 30	
	2018	2017	2018	2017
Benefit administration services and COBRA	\$96,258	\$99,338	\$200,699	\$205,923
Interchange	13,555	13,915	29,300	28,952
Other revenue	6,695	3,879	13,150	8,294
	\$116,508	\$117,132	\$243,149	\$243,169

Contract Balances

We generally do not recognize revenue in advance of invoicing our customers, however, we record a receivable when revenue is recognized prior to payment and we have unconditional right to payment. Alternatively, when payment precedes the related services, we record a contract liability, or deferred revenue, until our performance obligations are satisfied. Our deferred revenue as of June 30, 2018 and December 31, 2017 was \$12.5 million and \$3.4 million, net of \$1.0 million of contract assets, respectively. The balances related to cash received in advance for a certain interchange revenue arrangement, other up-front fees and other commuter deferred revenue. The Company expects to satisfy its remaining obligations for these arrangements.

Contract Costs

Contract costs relate to incremental costs of obtaining a contract with a customer. Contract costs, which primarily consist of deferred sales commissions, were \$9.6 million and \$9.3 million as of June 30, 2018 and March 31, 2018, respectively and are included in other assets on the condensed consolidated balance sheets. Amortization expense for the deferred costs was \$0.7 million and \$1.4 million for the three and six months ended June 30, 2018. There was no impairment loss in relation to the costs capitalized for the periods presented. Deferred contract costs are amortized on a straight-line basis over the period of benefit, which is consistent with the pattern of transfer of the good or service to

which the asset relates. The Company has applied the practical expedient which allows an entity to account for incremental costs of obtaining a contract at a portfolio level.

Performance Obligations

During the three and six months ended June 30, 2018, the Company recognized revenue of (\$0.5) million and (\$0.3) million attributable to changes in the estimated transaction price allocated to performance obligations satisfied in prior periods.

The following table includes estimated revenue expected to be recognized in the future related to performance obligations that are unsatisfied or partially unsatisfied at the end of the reporting period, in thousands. The Company applies the practical expedient to not disclose information about contracts with original expected durations of one year or less, amounts of variable consideration attributable to the variable consideration allocation exception, or contract renewals that are unexercised as of June 30, 2018 (in thousands):

17

Table of Contents

Notes to Condensed Consolidated Financial Statements (continued)
(Unaudited)

2018	2019	2020	2021 and thereafter	Total
\$286	571	571	1,714	\$3,142

Impacts on Financial Statements

In accordance with Topic 606, the disclosure of the impact of adoption to our unaudited condensed consolidated statements of income and balance sheets and statements of cash flows was as follows (in thousands, except per share amounts):

	Three Months Ended June 30, 2018			Six Months Ended June 30, 2018		
	As reported	Adjustments	Balance without adoption of ASC 606	As reported	Adjustments	Balance without adoption of ASC 606
Operating expenses:						
Sales and marketing	\$18,521	\$ 245	\$18,766	\$36,859	\$ 294	\$37,153
Total operating expenses	99,998	245	100,243	211,852	294	212,146
Income from operations	16,510	(245)	16,265	31,297	(294)	31,003
Income before income taxes	15,545	(245)	15,300	29,416	(294)	29,122
Income tax provision	(4,621)	73	(4,548)	(7,473)	75	(7,398)
Net income	\$10,924	\$ (172)	\$10,752	\$21,943	\$ (219)	\$21,724
Net income per share:						
Basic	\$0.27		\$0.27	\$0.55		\$0.55
Diluted	\$0.27		\$0.27	\$0.54		\$0.54

	June 30, 2018		
	As reported	Adjustments	Balance without adoption of ASC 606
Assets			
Other assets	\$28,839	\$ (7,175)	\$21,664
Total assets	1,635,960	(7,175)	1,628,785

Liabilities and Stockholders' Equity

Retained earnings	101,639	(7,175	)	94,464
Total Stockholders' equity	\$651,587	(7,175	)	\$644,412

Note 4 Goodwill and Intangible Assets

Goodwill

There is no change in the carrying amount of goodwill for the three and six months ended June 30, 2018.

Intangible Assets

Acquired intangible assets at June 30, 2018 and December 31, 2017 were comprised of the following (in thousands):

	June 30, 2018			December 31, 2017				
	Gross carrying amount	Accumulated amortization	Net	Gross carrying amount	Accumulated amortization	Net		
Amortizable intangible assets:								
Client / broker contracts and relationships	\$237,431	\$(96,695	)	\$140,736	\$237,221	\$(84,581	)	\$152,640
Trade names	3,880	(3,540	)	340	3,880	(3,492	)	388
Technology	14,646	(13,528	)	1,118	14,646	(13,047	)	1,599
Noncompete agreements	2,232	(2,048	)	184	2,232	(2,013	)	219
Favorable lease arrangements	1,134	(662	)	472	1,134	(611	)	523
Total	\$259,323	\$(116,473	)	\$142,850	\$259,113	\$(103,744	)	\$155,369

Amortization of intangible assets totaled \$6.3 million and \$6.5 million for the three months ended June 30, 2018 and 2017, respectively. For the six months ended June 30, 2018 and 2017, amortization expense of intangible assets was \$12.7 million and \$13.0 million, respectively.

Acquired intangible assets are amortized on a straight-line basis generally over one to ten years.

The estimated amortization expense in future periods at June 30, 2018 is as follows (in thousands):

	As of June 30, 2018
Remainder of 2018	\$12,737
2019	24,914
2020	22,749
2021	19,945
2022	17,509
Thereafter	44,996
Total	\$142,850

Table of Contents

Notes to Condensed Consolidated Financial Statements (continued)
(Unaudited)

19

Table of ContentsNotes to Condensed Consolidated Financial Statements (continued)
(Unaudited)

Note 5 Investments and Fair Value Measurements

The following table summarizes the Company's investments in marketable securities and fair value measurements by investment category reported as cash equivalents and short-term investments as at June 30, 2018 (in thousands):

	Carrying Amount	Gross Unrealized Gain	Gross Unrealized Loss	Fair Value	Level 1	Level 2
Cash equivalents:						
Money market funds	\$209	\$ —	\$ —	\$209	\$209	\$—
Commercial paper	20,793	1	(1	) 20,793	—	20,793
Total cash equivalents	\$21,002	\$ 1	\$ (1	) \$21,002	\$209	\$20,793
Short-Term Investments:						
U.S. government securities	\$28,970	\$ —	\$ (141	) \$28,829	\$28,829	\$—
U.S. government agency securities	14,325	—	(84	) 14,241	—	14,241
Municipal bonds	6,981	—	(11	) 6,970	—	6,970
Foreign government securities	10,505	—	(27	) 10,478	—	10,478
Corporate debt securities	143,209	35	(910	) 142,334	—	142,334
Commercial paper	21,661	1	(3	) 21,659	—	21,659
Certificates of deposit	1,257	1	—	1,258	—	1,258
Asset-backed securities	31,559	—	(233	) 31,326	—	31,326
Total short-term investments	\$258,467	\$ 37	\$ (1,409	) \$257,095	\$28,829	\$228,266
Total cash equivalents and short-term investments	\$279,469	\$ 38	\$ (1,410	) \$278,097	\$29,038	\$249,059

The following table summarizes the Company's investments in marketable securities and fair value measurements by investment category reported as cash equivalents and short-term investments as at December 31, 2017 (in thousands):

	Carrying Amount	Gross Unrealized Gain	Gross Unrealized Loss	Fair Value	Level 1	Level 2
Cash equivalents:						
Money market funds	\$58,953	\$ —	\$ —	\$58,953	\$58,953	\$—
Commercial paper	21,930	—	(3	) 21,927	—	21,927
Total cash equivalents	\$80,883	—	\$ (3	) \$80,880	\$58,953	\$21,927
Short-Term Investments:						
U.S. government securities	\$17,472	\$ —	\$ (41	) \$17,431	\$17,431	\$—
U.S. government agency securities	11,540	—	(30	) 11,510	—	11,510
Municipal bonds	6,974	2	(8	) 6,968	—	6,968
Foreign government securities	7,499	—	(27	) 7,472	—	7,472
Corporate debt securities	105,144	3	(273	) 104,874	—	104,874
Commercial paper	30,798	1	(9	) 30,790	—	30,790
Certificates of deposit	1,255	—	—	1,255	—	1,255
Asset-backed securities	15,310	—	(76	) 15,234	—	15,234

Edgar Filing: WAGEWORKS, INC. - Form 10-Q

Total short-term investments	\$195,992	\$	6	\$ (464)	\$195,534	17,431	\$178,103
Total cash equivalents and short-term investments	\$276,875	\$	6	\$ (467)	\$276,414	\$76,384	\$200,030

20

Table of ContentsNotes to Condensed Consolidated Financial Statements (continued)
(Unaudited)

As of June 30, 2018, the Company had no investments that were in an unrealized loss position for a period of twelve months or greater and have determined that the gross unrealized losses on investments are temporary in nature.

Realized gains and losses on marketable securities are included in other income (expense) on the Company's consolidated statements of income. Gross realized gains and losses on marketable securities for the three and six months ended June 30, 2018 were not significant.

The Company uses inputs such as actual trade data, benchmark yields, quoted market prices from dealers or brokers, and other similar sources to determine the fair value of its investments. There were no transfers between Level 1 and Level 2 fair value categories during the periods presented.

The following table summarizes the estimated amortized cost and fair value of the Company's marketable securities by the contractual maturity date as of June 30, 2018 (in thousands):

Amortized Cost	Fair Value
Due	
less	
the	
one	
year	
Due	
in	
one	
to	
five	
years	
Total	
\$11,212	\$140,904
\$138,258	137,194
\$279,470	\$278,098

The following table summarizes the estimated amortized cost and fair value of the Company's marketable securities by the contractual maturity date as of December 31, 2017 (in thousands):

Amortized Cost	Fair Value
Due	
less	
the	
one	
year	
Due	
in	
one	
to	
\$157,651	\$157,573
\$10,224	118,841

five
years
Total \$276,875 \$276,414

Note 6 Receivables

Receivables at June 30, 2018 and December 31, 2017 were comprised of the following (in thousands):

	June 30, 2018	December 31, 2017
Trade receivables	\$52,974	\$ 58,067
Unpaid amounts for benefit services	36,835	52,054
Receivables, gross	89,809	110,121
Less: allowance for doubtful accounts	(2,672)	(2,574)
Receivables, net	\$87,137	\$ 107,547

Note 7 Property and Equipment

Property and equipment at June 30, 2018 and December 31, 2017 were comprised of the following (in thousands):

	June 30, 2018	December 31, 2017
Computers and equipment	\$27,496	\$ 22,702
Software and software development costs	132,709	120,278
Furniture and fixtures	8,089	7,754
Leasehold improvements	28,836	25,097
	\$197,130	\$ 175,831
Less: accumulated depreciation and amortization	(118,644)	(107,089)
Property and equipment, net	\$78,486	\$ 68,742

As of June 30, 2018 and December 31, 2017, total assets under capital lease obligations were \$1.8 million and \$1.7 million respectively, and were classified as computers and equipment. Accumulated depreciation for assets under capital lease obligations was \$1.3 million and \$1.1 million as at June 30, 2018 and December 31, 2017 respectively.

The Company capitalized software development costs of \$5.9 million and \$5.5 million for the three months ended June 30, 2018 and 2017, respectively; and \$11.6 million and \$9.6 million for the six months ended June 30, 2018 and 2017, respectively. Amortization expense related to capitalized software development costs was \$3.8 million and \$2.9 million for the three months ended June 30, 2018 and 2017, respectively; and \$7.4 million and \$5.6 million for the six months ended June 30, 2018 and 2017, respectively. These costs are included in amortization and change in contingent consideration in the condensed consolidated statements of income. At June 30, 2018, the unamortized software development costs included in property and equipment in the condensed consolidated balance sheets were \$38.7 million.

Total depreciation expense plus amortization of software and capitalized software development costs for the three months ended June 30, 2018 and 2017 was \$7.3 million, \$5.6 million, respectively. Total depreciation cost, including amortization of software and capitalized software development costs, for the six months ended June 30, 2018 and 2017, was \$14.1 million and \$10.9 million, respectively.

Note 8 Accounts Payable and Accrued Expenses

Accounts payable and accrued expenses at June 30, 2018 and December 31, 2017 were comprised of the following (in thousands):

	June 30, 2018	December 31, 2017
Payable to benefit providers and transit agencies	25,533	32,469
Accounts payable and accrued liabilities	21,161	23,788
Accrued compensation and related benefits	26,172	25,921
Other accrued expenses	5,312	5,275
Deferred revenue	10,869	2,524
Accounts payable and accrued expenses	\$89,047	\$ 89,977

Table of ContentsNotes to Condensed Consolidated Financial Statements (continued)
(Unaudited)

Note 9 Long-term debt

As of June 30, 2018 and December 31, 2017, long-term debt consisted of the following (in thousands):

	June 30, 2018	December 31, 2017
Revolving credit facility used	\$249,830	\$ 249,830
Less: Outstanding letters of credit	(2,830)	(2,830)
Outstanding revolving credit facility	247,000	247,000
Unamortized loan origination fees	(2,343)	(2,085)
Long-term debt	\$244,657	\$ 244,915

On April 4, 2017, the Company entered into a Second Amended and Restated Credit Agreement (the “Credit Agreement”) with MUFG Union Bank, N.A., as administrative agent (“Agent”). The Credit Agreement amends and restates the Company’s existing Amended and Restated Credit Agreement, and increased the Company’s borrowing capacity under the revolving credit facility to \$400.0 million, with a \$15.0 million letter of credit sub-facility. The Credit Agreement contains an increase option permitting the Company, subject to certain conditions and requirements, to arrange with existing lenders and/or new lenders to provide up to an aggregate of \$100.0 million in additional commitments. Loan proceeds may be used for general corporate purposes, including acquisitions permitted under the Credit Agreement. The Company may prepay loans under the Credit Agreement in whole or in part at any time without premium or penalty. The fees incurred in connection with the Credit Agreement are classified as a direct deduction from long-term debt in the condensed consolidated balance sheets.

The loans bear interest, at the Company’s option, at either (i) a London Interbank Offered Rate (LIBOR) determined in accordance with the Credit Agreement, plus a margin ranging from 1.25% to 2.25%, or (ii) a base rate determined in accordance with the Credit Agreement, plus a margin ranging from 0.25% to 1.25%, in either case with such margin determined based on the Company’s consolidated leverage ratio for the preceding four fiscal quarter period. Interest is due and payable in arrears quarterly for base rate loans and at the end of an interest period for LIBOR rate loans. Principal, together with all accrued and unpaid interest, is due and payable on April 4, 2022. The Company elected option (i) and, as of June 30, 2018, the interest rate applicable to the revolving credit facility was 3.55%.

The Company’s obligations under the Credit Agreement are secured by substantially all of the Company’s assets. All of the Company’s existing and future material subsidiaries are required to guarantee its obligations under the Credit Agreement. The guarantees by future material subsidiaries are and will be secured by substantially all of the assets of such subsidiaries.

The Credit Agreement contains financial and non-financial covenants including debt ratio and interest coverage ratio requirements. The Company is currently in compliance with all the covenants under the credit facility.

On April 5, 2018, the Company’s Board of Directors concluded the previously issued financial statements for (i) the quarterly periods ended September 30, June 30 and March 31, 2017, (ii) the annual period ended December 31, 2016 and (iii) the quarterly periods ended September 30 and June 30, 2016 (collectively, the “Non-Reliance Periods”) should be restated and should no longer be relied upon. On March 22, 2018 the Company entered a “First Reporting Extension” Agreement and on June 25, 2018 entered a “Second Reporting Extension” Agreement. These agreements are amendments to the Credit Agreement dated April 4, 2017 and provide credit accommodations to the Company in the

form of modification of the reporting and Compliance Certificates. In 2018, the Company paid the Agent \$0.8 million to extend the delivery date of the delinquent financial statements to March 16, 2019 pursuant to the Reporting Extension Agreement. In March 2019, the Company entered into a Third Reporting Extension Agreement and paid the Agent \$0.1 million to extend the delivery date of any remaining delinquent financial statements to May 10, 2019.

As of June 30, 2018, the Company had \$247.0 million outstanding under the revolving credit facility and \$150.2 million unused revolving credit facility still available to borrow under the Credit Agreement.

The credit facility 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

Table of ContentsNotes to Condensed Consolidated Financial Statements (continued)
(Unaudited)

applicable interest rate. Upon an event of default, the lenders may terminate the commitments, declare the outstanding obligations payable by the Company to be immediately due and payable, and exercise other rights and remedies provided for under the credit facility.

Note 10 Organizational Efficiency Plan

During the second quarter of 2015, the Company integrated operations and consolidated certain positions resulting in employee headcount reductions. The Company continually evaluates ways to improve business processes to ensure that operations align with its strategy and vision for the future. During the three and six months ended June 30, 2018, the Company recorded a charge of \$2.9 million for employee termination costs primarily related to severance costs. During the three and six months ended June 30, 2017, the Company recorded a charge of \$0.9 million and \$1.6 million, respectively, for employee termination costs primarily related to severance costs.

Note 11 Employee Benefit Plans

Stock-based compensation

Stock-based compensation is classified in the condensed consolidated statements of income in the same expense line items as cash compensation. Amounts recorded as expense in the condensed consolidated statements of income were as follows (in thousands):

	Three Months		Six Months	
	Ended June 30,		Ended June 30,	
	2018	2017	2018	2017
Cost of revenues	\$660	\$2,007	\$2,327	\$3,747
Technology and development	586	600	1,161	1,211
Sales and marketing	772	624	1,750	1,410
General and administrative	(430)	3,802	3,643	4,444
Total	\$1,588	\$7,033	\$8,881	\$10,812

(a) Employee Stock Option Plan

In May 2010, the Company adopted the 2010 Equity Incentive Plan ("2010 Plan"). Under the 2010 Plan, the Company can grant share-based awards to all employees, including executive officers, outside consultants and non-employee directors. Options under 2010 Plan generally has a term of 10 years and vest over 4 years with 25% vesting after one year of service and monthly vesting over the remaining period. As of June 30, 2018, the 2010 Plan has a total of 5.1 million common stock shares available for issuance.

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

	Three	Six
	Months	Months
	Ended	Ended

Edgar Filing: WAGEWORKS, INC. - Form 10-Q

	June 30, 2017	June 30, 2017
Stock options granted (in thousands)	—27	—545
Weighted-average fair value at date of grant	\$—\$26.20	\$—\$26.72

Table of ContentsNotes to Condensed Consolidated Financial Statements (continued)
(Unaudited)

Stock option activity for the six months ended June 30, 2018 was as follows (shares in thousands):

	Shares	Weighted-average exercise price	Remaining contractual term (in years)	Aggregate intrinsic value (in thousands)
Outstanding at December 31, 2017	2,478	\$ 47.24	7.22	\$ 42,324
Granted	—	—		
Exercised	(54)	26.10		
Forfeited and cancelled	(28)	53.94		
Outstanding as of June 30, 2018	2,396	\$ 47.63	5.43	\$ 20,948
Vested and expected to vest at June 30, 2018	2,327	\$ 47.27	5.40	\$ 20,835
Exercisable at June 30, 2018	1,591	\$ 41.35	4.98	\$ 19,580

As of June 30, 2018, there was \$13.7 million of total unrecognized stock-based compensation expense associated with stock options which will be recognized over a weighted-average period of approximately 2 years. Total unrecognized compensation cost will be adjusted for future changes in estimated forfeitures.

(b) Restricted Stock Units

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

In the second quarter of 2017 and 2018 the Company granted no performance-based restricted stock units. During the first quarter of 2017, the Company granted a total of 343,000, of performance-based restricted stock units to certain executive officers. 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 200% of the target number of shares originally granted, depending on terms of the grant agreement.

Stock-based compensation expense related to restricted stock units was \$(1.1) million and \$4.1 million for the three months ended June 30, 2018 and 2017, respectively; and \$3.0 million and \$4.9 million for the six months ended June 30, 2018 and 2017, respectively. Total unrecorded stock-based compensation expense at June 30, 2018 associated with restricted stock units was estimated at \$15.9 million, which is expected to be recognized over a weighted-average period of approximately 2 years.

The following table summarizes information about restricted stock units issued to officers, directors and employees under the 2010 Plan (shares in thousands):

	(Shares in thousands)	Weighted-average grant date fair value		
Service- based RSUs	Performance- based RSUs	Service- based RSUs	Performance- based RSUs	
Unvested at December 31, 2017	304	725	\$ 61.61	\$ 60.21

Edgar Filing: WAGEWORKS, INC. - Form 10-Q

Granted	—	—	—	—
Vested	(57)	(140)	) 62.06	61.10
Forfeited and cancelled	(10)	(210)	) 62.94	60.01
Unvested at June 30, 2018	237	375	\$ 61.45	\$ 60.00

25

Table of Contents

Notes to Condensed Consolidated Financial Statements (continued)
(Unaudited)

Note 12 Stockholders' Equity

Share Repurchase Program

On August 6, 2015, the Company's Board of Directors authorized a \$100 million stock repurchase program for 3 years which commenced on November 5, 2015 and expires on November 4, 2018. Repurchases made under this program may be made in the open market as the Company deems appropriate and market conditions allow. There were no shares of common stock repurchased during the three and six months ended June 30, 2018 and 2017. In August 2017, the Company repurchased 134,900 shares of its common stock at an average price of \$58.82 per share for a total cost of \$7.9 million. As of June 30, 2018, the Company had \$77.7 million available for future purchases under the stock repurchase program.

Note 13 Income Taxes

The Company reports 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 on-going in the jurisdictions where the Company operates.

The Company's effective tax rate was 29.7% and 43.6% for the three months ended June 30, 2018 and 2017, respectively and 25.4% and 1.9% for the six months ended June 30, 2018 and 2017, respectively. The income tax provision for the three months ended June 30, 2018 was \$4.6 million and the income tax benefit for the three months ended June 30, 2017 was \$6.2 million. The income tax provision for the six months ended June 30, 2018 was \$7.5 million and the income tax benefit for the six months ended June 30, 2017 was \$0.7 million.

As of June 30, 2018, 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.

Note 14 Commitments and Contingencies

(a) Capital Lease Obligations

The Company leases equipment under capital lease obligations that expire at various expiration dates through 2020. Future minimum lease payments under capital lease obligations as of June 30, 2018 are \$0.6 million. The Company recorded current and long-term portions of capital lease obligations under other current liabilities and non-current liabilities, respectively, in the consolidated balance sheets. The Company has no future minimum lease payments under capital lease obligations extending beyond 2020.

(b) Operating Leases

The Company leases office space and equipment under noncancelable operating leases with various expiration dates through 2028. Future minimum lease payments under noncancelable operating leases, excluding the contractual sublease income of \$9.2 million, are as follows (in thousands):

	As of June 30, 2018
Remainder of 2018	\$ 4,594
2019	9,518
2020	9,720
2021	9,689
2022	6,536
Thereafter	7,970
Total future minimum lease payments	\$ 48,027

Rent expense for the three months ended June 30, 2018 and 2017 was \$1.9 million and \$1.9 million, respectively, and \$3.9 million and \$3.9 million for the six months ended June 30, 2018 and 2017, respectively. Sublease income for the three and six months ended June 30, 2018 was \$0.5 million and \$0.9 million, respectively. There was \$0.5 million and \$0.8 million sublease income recognized for the same periods in 2017, respectively.

(c) Legal Matters

The Company is pursuing affirmative claims against the OPM to obtain payment for services provided by the Company between March 1, 2016 and August 31, 2016 pursuant to our contract with OPM for the Government's Federal Flexible Account Program ("FSAFEDS"). The Company initially issued its invoice for these services in February 2017. On December 22, 2017, the Company received the Contracting Officer's "final decision" refusing payment of the invoiced amount and otherwise denying the Company's Certified Claim. As a result of this decision, and a related Certified Claim that OPM subsequently denied, on February 8, 2018, we filed an appeal to the Civilian Board of Contract Appeals ("CBCA") against OPM for services provided by the Company between March 1, 2016 and August 31, 2016. On August 3, 2018, we filed an appeal to the CBCA of OPM's June 21, 2018 denial of a Request for Equitable Adjustment for extra work associated with a contract modification imposing new security and other requirements not part of the original scope of FSAFED's contract work. The aggregate amount of our claims is approximately \$9.1 million. The cases have been consolidated and discovery is ongoing.

There have been multiple discovery motions, as well as motion to dismiss the claim we filed on August 3, 2018 which has been fully briefed and is awaiting a decision by the CBCA. The cases have been set for a hearing on the merits on April 24, 2019. However, because of the recent partial Government shutdown, the trial date has been postponed and has been tentatively scheduled for mid-June 2019. In connection with the Company's claims against OPM, OPM has also claimed that an erroneous statement in a certificate signed by a former executive officer constituted a violation of

the False Claims Act, and has moved to dismiss part of our claim against OPM as a result. As with all legal proceedings, no assurance can be provided as to the outcome of these matters or if we will be successful in recovering the full claimed amount.

On March 9, 2018, a putative class action - captioned Government Employees' Retirement System of the Virgin Islands v. WageWorks, Inc., et al., No. 4:18-cv-01523-JSW - was filed in the United States District Court for the Northern District of

California (the “Securities Class Action”) against the Company, our former Chief Executive Officer, and our former Chief Financial Officer. The complaint asserts claims under Sections 10(b) and 20(a) of the Securities Exchange Act of 1934, as amended (the “Exchange Act”), on behalf of persons and entities that acquired WageWorks securities between May 6, 2016 and March 1, 2018, and alleges, among other things, that the defendants issued false and misleading financial statements. The plaintiffs seek unspecified damages, fees, interest, and costs. The Company believes that the claims are without merit. On August 7, 2018, the Court entered an order granting the motion of the Public Pension Group, consisting of Public Employees’ Retirement System of Mississippi, the Government Employees’ Retirement System of the Virgin Islands, and the New Mexico Public Employees Retirement Association of New Mexico, to be lead plaintiff. Under the schedule stipulated by the parties, and approved by the Court, lead plaintiff will file its consolidated amended complaint no later than forty-five (45) days following issuance of the Company’s Restatement.

On June 22, 2018 and September 6, 2018, two derivative lawsuits were filed against certain of our officers and directors and the Company (as nominal defendant) in the Superior Court of the State of California, County of San Mateo. Pursuant to the parties’ stipulation, which was approved by the Superior Court, the actions were consolidated. On July 23, 2018, a similar derivative lawsuit was filed against certain of our officers and directors and the Company (as nominal defendant) in the United States District Court for the Northern District of California (together, the “Derivative Suits”). The Derivative Suits purport to allege claims related to breaches of fiduciary duties, waste of corporate assets, and unjust enrichment. In addition, the complaint in District Court includes a claim for abuse of control, and the complaint in Superior Court includes a claim to require the Company to hold an annual shareholder meeting. The allegations in the Derivative Suits relate to substantially the same facts as those underlying the Securities Class Action described above. The plaintiffs seek unspecified damages and fees and costs. In addition, the complaint in the Superior Court seek for us to provide past operational reports and financial statements, to publish timely and accurate operational reports and financial statements going forward, to hold an annual shareholder meeting, and to take steps to improve its corporate governance and internal procedures.

Under the schedule stipulated by the parties, and approved by the Superior Court, the plaintiff in the Superior Court action will file its Consolidated Complaint within 45 days from the date we issue our Restatement. As stipulated by the parties, and approved by the District Court, the District Court action is stayed. The parties in the District Court action are to notify the District Court within 15 days of (1) the dismissal of the Securities Class Action, (2) the denial of defendants' motion(s) to dismiss, or (3) a party giving notice that they no longer consent to the voluntary stay.

From time to time, the Company may become involved in legal proceedings, claims and litigation arising in the ordinary course of business.

The Company voluntarily contacted the San Francisco office of the SEC Division of Enforcement regarding the restatement and independent investigation. The Company is providing information and documents to the SEC and will continue to cooperate with the SEC’s investigation into these matters. The U.S. Attorney’s Office for the Northern District of California also opened an investigation. The Company has provided documents and information to the U.S. Attorney’s Office and will continue to cooperate with any inquiries by the U.S. Attorney’s Office regarding the matter.

The Company records a provision for contingent losses when it is both probable that a liability has been incurred and the amount of the loss can be reasonably estimated. Based on currently available information, the Company does not believe that any additional liabilities relating to other unresolved matters are probable or that the amount of any resulting loss is estimable. However, litigation is subject to inherent uncertainties and the Company's view of these matters may change in the future. Were an unfavorable outcome to occur, there exists the possibility of a material adverse impact on the Company's financial position, results of operations or cash flows for the period in which the unfavorable outcome occurs, and potentially in future periods.

Note 15 Subsequent Events

The Company's former Chief Executive Officer Joe Jackson resigned from his position as Executive Chairman of the Company effective September 6, 2018. Mr. Jackson executed a release of claims with the Company as part of his resignation providing him with certain compensation and benefits, as described in the Form 8-K filed with the U.S. Securities and Exchange Commission on September 12, 2018.

Table of Contents

Notes to Condensed Consolidated Financial Statements (continued)
(Unaudited)

On October 15, 2018, Mr. Ismail Dawood was appointed Chief Financial Officer of the Company after previously serving as the Interim Chief Financial Officer and principal financial officer since April 9, 2018, and on January 14, 2019, Mr. John G. Saia joined the Company as Senior Vice President, General Counsel and Corporate Secretary.

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, and Section 21E of the Securities Exchange Act of 1934, as amended. 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," "should," "target," "will," "would" and similar 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, opportunities for portfolio purchases, acquisitions, channel partnerships and carrier relationships, 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 in Part I, Item 1A, "Risk Factors", of our Annual Report on Form 10-K for the year ended December 31, 2017. 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 ("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 Savings Accounts ("HSAs"), health and dependent care Flexible Spending Accounts ("FSAs"), Health Reimbursement Arrangements ("HRAs"), as well as Commuter Benefit Services, including transit and parking programs, wellness programs, Consolidated Omnibus Budget Reconciliation Act ("COBRA"), and other employee 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 portions of their healthcare, dependent care, and commuter expenses. Employers financially benefit from our programs through reduced payroll taxes, the benefits of which are realized 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.

Our services are priced based on the estimated number and types of claims, whether payment processing and client support activities will be provided within or outside of the United States, the estimated number of calls to our customer support center, and any specific client requirements. In addition, we derive a portion of our revenues from interchange fees that we receive when employee participants use the prepaid debit cards we provide to them for healthcare and commuter expenses.

Critical Accounting Policies and Significant Management Estimates

Other than the adoption of ASU 2014-09, "Revenue from Contracts with Customers (Topic 606)" and ASU 2016-18, Statement of Cash Flows (Topic 230): Restricted Cash, there have been no material changes to our critical accounting policies and estimates during the six months ended June 30, 2018, as compared to the critical accounting policies and estimates disclosed in the "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, 2017.

Results of Operations

Revenue

Revenue and changes in revenue by product for the three and six months ended June 30, 2018 and 2017 were:

	Three Months Ended June 30,				Six Months Ended June 30,					
	2018	2017	\$	%	2018	2017	\$	%	Change	Change
(Dollar in thousands)	Amount	Amount	Change	Change	Amount	Amount	Change	Change		
Revenues:										
Healthcare	\$68,104	\$68,202	\$(98)	— %	\$143,361	\$142,876	\$485	— %		
COBRA	26,200	27,018	(818)	(3)%	55,035	55,568	(533)	(1)%		
Commuter	18,847	17,836	1,011	6 %	37,725	36,379	1,346	4 %		
Other	3,357	4,076	(719)	(18)%	7,028	8,346	(1,318)	(16)%		
Total revenues	\$116,508	\$117,132	\$(624)	(1)%	\$243,149	\$243,169	\$(20)	— %		

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' FSAs, HRAs, and HSAs. We also earn interchange revenue paid by financial institutions related to transaction fees on debit cards used by employee participants in connection with all of our healthcare programs and through our wholesale card program and revenue from self-service plan kits called Premium Only Plan kits, or POP revenue.

Healthcare revenue decreased by \$0.1 million, or 0% for the three months ended June 30, 2018, as compared to the same period in 2017. The decrease was primarily driven by changes in employee participation for HSA.

Healthcare revenue increased by \$0.5 million, or 0% for the six months ended June 30, 2018, as compared to the same period in 2017. Healthcare revenue increased due to the addition of new clients and growth in new employee participation for HSA; an increase in interchange fee and other incentive revenue as a result of a contract renegotiation for our debit card usage; and an increase in interest earned on HSA custodian assets.

COBRA Revenue

COBRA revenue is derived from 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, and vision, and for the continued administration of the employee participants' HRAs and certain healthcare FSAs.

COBRA revenue decreased by \$0.8 million, or 3% for the three months ended June 30, 2018, as compared to the same period in 2017. The decrease was primarily driven by client terminations.

COBRA revenue decreased by \$0.5 million, or 1% for the six months ended June 30, 2018, as compared to the same period in 2017. The decrease was primarily driven by client terminations offset by an increase in annual notice fees.

Commuter Revenue

We derive our commuter revenue from monthly service fees paid by our employer clients, interchange revenue paid by financial institutions related to transaction fees on debit cards used by employee participants in connection with our commuter solutions, and commissions from the sale of transit passes used in our commuter solutions which we purchase from various transit agencies on behalf of employee participants.

Commuter revenue increased by \$1.0 million, or 6% for the three months ended June 30, 2018, as compared to the same period in 2017. The increases were primarily due to the addition of new clients and growth in the number of employee participation and an increase in interchange fee revenue.

Table of Contents

Commuter revenue increased by \$1.3 million, or 4% for the six months ended June 30, 2018, as compared to the same period in 2017. The increases were primarily due to the addition of new clients and growth in the number of employee participation and an increase in interchange fee revenue.

Other Revenue

Other revenue includes enrollment and eligibility services, employee account administration (i.e., tuition and health club reimbursements), project-related professional fees and other program incentives.

Other revenue decreased by \$0.7 million or 18% for the three months ended June 30, 2018, as compared to the same period in 2017. The decrease was primarily due to a decrease in revenue from enrollment and eligibility services due to client terminations.

Other revenue decreased by \$1.3 million or 16% for the six months ended June 30, 2018, as compared to the same period in 2017. The decrease was primarily due to a decrease in revenue from enrollment and eligibility services due to client terminations.

Cost of Revenues

(Dollar in thousands)	Three Months Ended June 30,				Six Months Ended June 30,			
	2018	2017	\$ Change	% Change	2018	2017	\$ Change	% Change
Cost of revenues (excluding amortization of internal use software)	\$36,143	\$43,319	\$(7,176)	(17)%	\$81,386	\$91,407	\$(10,021)	(11)%
Percentage of revenue	31	% 37	%		33	% 38	%	

Cost of revenues consist of direct expenses for claims processing, product support, and customer service personnel, outsourced and temporary labor, check/ACH payment processing services, debit card processing services, shipping and handling, passes, and employee participant communications.

Cost of revenues decreased by \$7.2 million or 17% for the three months ended June 30, 2018, as compared to the same period in 2017. Cost of revenues decreased by \$10.0 million or 11% for the six months ended June 30, 2018, as compared to the same period in 2017. The decreases were primarily due to a decrease in compensation and related benefits associated with the headcount that occurred in the third quarter of 2017 and a reduction in outsourced services.

As we grow organically and through portfolio purchases, acquisitions, and channel partner arrangements, 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, 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 is targeted to occur within 12 to 24 months of the portfolio acquisition date.

Operating Expenses

Technology and Development

Edgar Filing: WAGEWORKS, INC. - Form 10-Q

(Dollar in thousands)	Three Months Ended June 30,				Six Months Ended June 30,			
	2018	2017	\$ Change	% Change	2018	2017	\$ Change	% Change
Technology and development	\$13,392	\$14,515	\$(1,123)	(8)%	\$26,425	\$29,786	\$(3,361)	(11)%
Percentage of revenue	11	% 12	%		11	% 12	%	

Technology and development expenses consist of personnel and related expenses, outsourced programming services, on-demand technology infrastructure, and expenses associated with equipment and software development and licenses.

Table of Contents

Technology and development expenses decreased by \$1.1 million, or 8% for the three months ended June 30, 2018, as compared to the same period in 2017. Technology and development expenses decreased by \$3.4 million, or 11% for the six months ended June 30, 2018, as compared to the same period in 2017. The decrease was primarily due to a decrease in outsourced services offset by an increase in software expenses.

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. The timing of development and enhancement projects, including the nature of expenditures as well as the phase of the project that could require capitalization or expense treatment, will significantly affect our technology and development expense both in dollar amount and as a percentage of revenues.

Sales and Marketing

	Three Months Ended June 30,				Six Months Ended June 30,			
	2018	2017	\$ Change	% Change	2018	2017	\$ Change	% Change
(Dollar in thousands)								
Sales and marketing	\$18,521	\$14,728	\$3,793	26 %	\$36,859	\$30,807	\$6,052	20 %
Percentage of revenue	16	% 13	%		15	% 13	%	

Sales and marketing expenses consist primarily of compensation 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.

Sales and marketing expenses increased by \$3.8 million or 26% for the three months ended June 30, 2018, as compared to the same period in 2017. Sales and marketing expenses increased by \$6.1 million or 20% for the six months ended June 30, 2018, as compared to the same period in 2017. The increase was primarily due to an increase in compensation, benefit costs and direct sales commissions associated with overall growth in revenue, partially offset by a decrease in outsourced services.

We continue to invest in sales, client services, and marketing by hiring additional personnel and continuing to build our broker and channel relationships. We will also 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,				Six Months Ended June 30,			
	2018	2017	\$ Change	% Change	2018	2017	\$ Change	% Change
(Dollar in thousands)								
General and administrative	\$18,898	\$18,459	\$439	2 %	\$44,147	\$31,959	\$12,188	38 %
Percentage of revenue	16	% 16	%		18	% 13	%	

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

General and administrative expenses increased by \$0.4 million or 2% for the three months ended June 30, 2018, as compared to the same period in 2017. General and administrative expenses increased by \$12.2 million or 38% for the six months ended June 30, 2018, as compared to the same period in 2017. The increase was primarily due to increase in professional fees related to legal and accounting fees attributed to the restatement and audit committee

investigations.

To support our continued growth, we expect our general and administrative expenses to continue to increase in absolute dollars as we expand general and administrative headcount.

31

Table of Contents

Amortization

	Three Months Ended June 30,				Six Months Ended June 30,			
	2018	2017	\$ Change	% Change	2018	2017	\$ Change	% Change
(Dollar in thousands)								
Amortization	\$ 10,191	\$ 9,393	\$ 798	8 %	\$ 20,182	\$ 18,630	\$ 1,552	8 %
Percentage of revenue	9	% 8	%		8	% 8	%	

Our amortization charge consists of two components: amortization of internal use software and amortization of acquired intangible assets. We capitalize our software development costs related to the development and enhancement of our business solutions. When the technology is available for its intended use, the capitalized costs are amortized over the technology's estimated useful life, which is generally four years. Acquisition-related intangible assets are also amortized over their estimated useful lives.

Amortization increased by \$0.8 million or 8% and increased by \$1.6 million or 8% for the three and six months ended June 30, 2018, respectively, as compared to the same periods in 2017. The increase was primarily driven by an increase in amortization resulting from the acquired intangibles from the Tango acquisition and an increase in amortization of internal use software due to increased investment in software development projects.

Employee Termination and Other Charges

	Three Months Ended June 30,				Six Months Ended June 30,			
	2018	2017	\$ Change	% Change	2018	2017	\$ Change	% Change
(Dollar in thousands)								
Employee termination and other charges	\$ 2,853	\$ 917	\$ 1,936	211 %	\$ 2,853	\$ 1,648	\$ 1,205	73 %
Percentage of revenue	2	% 1	%		1	% 1	%	

Employee termination and other charges increased by \$1.9 million for the three months ended June 30, 2018 as compared to the same periods in 2017. Employee termination and other charges increased by \$1.2 million for the six months ended June 30, 2018 as compared to the same periods in 2017. The increase was primarily attributable to executive departures in 2018.

Other Income (Expense), net

	Three Months Ended June 30,				Six Months Ended June 30,			
	2018	2017	\$ Change	% Change	2018	2017	\$ Change	% Change
(Dollar in thousands)								
Interest income	\$ 1,432	\$ 95	\$ 1,337	1,407 %	\$ 2,703	\$ 162	\$ 2,541	1,569 %
Interest expense	\$(2,420)	\$(1,766)	\$ 654	37 %	\$(4,602)	\$(3,202)	\$ 1,400	44 %
Other income (expense), net	\$ 23	\$(9)	\$ 32	356 %	\$ 18	\$(230)	\$ 248	108 %

Interest income increased for the three and six months ended June 30, 2018 due to our investment strategy implemented during the third quarter of 2017.

Interest expense increased by \$0.7 million or 37% and \$1.4 million or 44% for the three and six months ended June 30, 2018, respectively, as compared to the same periods in 2017. The increase in interest expense relates to borrowings on our revolving credit facility.

The increase in other income (expense), net for the six months ended June 30, 2018, as compared to the same periods in 2017, was primarily due to a one-time loss in our share of an equity investment.

Table of Contents

Income Taxes

(Dollar in thousands)	Three Months Ended June 30,				Six Months Ended June 30,			
	2018	2017	\$ Change	% Change	2018	2017	\$ Change	% Change
Income before income taxes	\$15,545	\$14,121			\$29,416	\$35,662		
Income tax (provision) benefit	\$(4,621)	\$6,157	\$(10,778)	(175)%	\$(7,473)	\$673	\$(8,146)	(1,210)%
Effective tax rate	29.7	% (43.6)			25.4	% (1.9)		

Income tax provision increased by \$10.8 million or 175% and increased by \$8.1 million or 1,210% for the three and six months ended June 30, 2018, respectively, as compared to the same periods in 2017. The income tax provision for the three and six months ended June 30, 2018 included net discrete tax benefits of \$0.5 million and \$14.8 million, respectively, to reflect the effects of the Tax Act on deduction of compensation.

Table of Contents

Liquidity and Capital Resources

As of June 30, 2018, our principal sources of liquidity were cash and cash equivalents totaling \$712.2 million and short-term investments totaling \$257.1 million comprised primarily of funding by clients of amounts to be paid on behalf of employee participants, public stock offerings and cash generated from ongoing operations.

We believe that our existing cash and cash equivalents, short-term investments, and the available credit from our revolving credit facility will be sufficient to meet our working capital, debt, capital expenditures, and stock repurchase needs, 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 employer clients, we receive prefunds that have been and are expected to continue to be a significant source of cash flows from operating activities. Our client contracts do not contain restrictions on our use of client prefunds and, as a result, each prefund is reflected in cash and cash equivalents on our consolidated balance sheet with an equivalent customer obligation recorded as a liability as the prefund is received. Changes in these prefunds and the corresponding customer obligations are reflected in our cash flows from operating activities. The timing of when employer clients make their prefunds as well as the timing of when we make payments on behalf of employee participants can significantly affect our cash flows.

The operation of these prefunds for our 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 and other factors. 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, the replenishment occurs 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 and the date payment is received from our employer clients for reimbursement of payments we have made on behalf of employee participants.

Revolving Credit Facility (Credit Agreement)

On April 4, 2017, we entered into a Second Amended and Restated Credit Agreement with MUFG Union Bank, N.A., as administrative agent, to increase the borrowing capacity to \$400.0 million, with a \$15.0 million letter of credit subfacility (the "Credit Agreement"). The Credit Agreement contains an increase option permitting us, subject to certain conditions and requirements, to arrange with existing lenders and/or new lenders to provide up to an aggregate of \$100 million in additional commitments. The loans bear interest, at our option, at either (i) a London Interbank Offered Rate (LIBOR) determined in accordance with the Credit Agreement, plus a margin ranging from 1.25% to 2.25%, or (ii) a base rate determined in accordance with the Credit Agreement, plus a margin ranging from 0.25% to 1.25%, in either case with such margin determined based on our consolidated leverage ratio for the preceding four fiscal quarter period. Interest is due and payable in arrears quarterly for base rate loans and at the end of an interest

period for LIBOR rate loans. Principal, together with all accrued and unpaid interest, is due and payable on April 4, 2022. Our obligations under the Credit Agreement are secured by substantially all of our assets. We elected option (i) and, as of June 30, 2018, the interest rate applicable to the revolving credit facility was 3.55%. All of our existing and future material subsidiaries are required to guarantee our obligations under the Credit Agreement. The guarantees by future material subsidiaries are and will be secured by substantially all of the assets of such subsidiaries. As of June 30, 2018, we have \$150.2 million available to borrow under the revolving credit facility. We are currently in compliance with all financial and non-financial covenants under the credit facility.

On April 5, 2018, our Board concluded the previously issued financial statements for (i) the quarterly periods ended September 30, June 30 and March 31, 2017, (ii) the annual period ended December 31, 2016 and (iii) the quarterly periods ended September 30 and June 30, 2016 should be restated and should no longer be relied upon. Consequently, we did not meet our obligation to provide our financial statements to the Agent by the contractual delivery date. In March 2018, we entered into a Reporting Extension Agreement (the "Extension Agreement"), by and among the Company, the lenders party thereto and MUFG Union Bank, N.A.,

Table of Contents

as administrative agent to extend the time period for delivery to Agent and the lenders our delinquent financial statements to June 30, 2018. In June 2018, we entered into a Second Reporting Extension Agreement and paid the Agent \$0.8 million to extend the delivery date of our delinquent financial statements to March 16, 2019. In March 2019, the Company entered into a Third Reporting Extension Agreement and paid the Agent \$0.1 million to extend the delivery date of any remaining delinquent financial statements to May 10, 2019.

Cash Flows

The following table presents information regarding our cash flow activities:

(in thousands)	Six Months Ended		
	2018	2017	\$ Change
Net cash provided by (used in) operating activities	\$13,559	\$(8,299)	\$21,858
Net cash used in investing activities	(82,105)	(17,931)	(64,174)
Net cash provided by financing activities	1,395	129,754	(128,359)
Net (decrease) increase in cash and cash equivalents, restricted and unrestricted	\$(67,151)	\$103,524	\$(170,675)

Cash Flows from Operating Activities

Net cash provided by operating activities increased \$21.9 million for the six months ended June 30, 2018 as compared to the same period in 2017. Cash provided by operating activities for the six months ended June 30, 2018 is primarily comprised of net income of \$21.9 million, adjusted upward for non-cash items of \$34.1 million driven by growth in our business and a decrease in the receivables balance. These increases were partially offset by a decrease in cash from customer obligations.

The non-cash items consisted mainly of amortization from acquired intangibles from 2016 acquisitions and stock-based compensation expense due to an increase in headcount and higher attainment of metrics from performance-based restricted stock units.

Cash Flows from Investing Activities

Net cash used in investing activities increased \$64.2 million for the six months ended June 30, 2018 as compared to the same period in 2017, primarily due to \$62.1 million net purchases of available-for-sale investments and a \$19.8 million investment in capital expenditures.

Cash Flows from Financing Activities

Net cash provided by financing activities decreased \$128.4 million for the six months ended June 30, 2018 as compared to the same period in 2017. The decrease primarily consisted of approximately \$131.2 million in proceeds from public stock offering in June 2017, net of paid underwriting discounts and commissions and other offering costs offset by a payment of \$2.5 million principal payment of debt in 2017. There was no public stock offering or debt repayment in 2018.

Contractual Obligations

The following table summarizes our significant contractual obligations as of June 30, 2018:

(in thousands)	Total	Less than 1 year	1-3 years	3-5 years	More than 5 years
Long-term debt obligations ⁽¹⁾	\$247,000	\$—	\$—	\$247,000	\$—
Interest on long-term debt obligations ⁽²⁾	33,408	8,760	17,519	7,129	—
Operating lease obligations ⁽³⁾	48,027	9,285	19,470	13,028	6,244
Total	\$328,435	\$18,045	\$36,989	\$267,157	\$6,244

As of June 30, 2018, maximum borrowings under the revolving credit facility are \$400.0 million with a base rate determined in accordance with the credit agreement or, at our option, LIBOR plus a spread of 1.25% to 2.25% per annum, and a maturity date of April 4, 2022. As of June 30, 2018, our outstanding principal of \$247.0 million is presented net of debt issuance costs on our condensed consolidated balance sheets. The debt issuance costs are not included in the table above.

⁽²⁾ Estimated interest payments assume the interest rate applicable as of June 30, 2018 of 3.55% per annum on a \$247.0 million outstanding principal amount.

⁽³⁾ We lease facilities under non-cancelable operating leases expiring at various dates through 2028.

Off-Balance Sheet Arrangements

Other than outstanding letters of credit issued under our revolving credit facility, we do not have any off-balance sheet arrangements. The majority of the standby letters of credit mature in one year. However, in the ordinary course of business, we will continue to renew or modify the terms of the letters of credit to support business requirements. The letters of credit are contingent liabilities, supported by our revolving credit facility, and are not reflected on our condensed consolidated balance sheets.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

There have been no material changes in our market risk during the six months ended June 30, 2018. For additional information, see Part II, Item 7A., “Quantitative and Qualitative Disclosures About Market Risk”, of our Annual Report on Form 10-K for the year ended December 31, 2017.

Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures.

Our management, with the participation of our Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of our disclosure controls and procedures (as such term is defined in Rule 13a-15(e) of the Securities Exchange Act of 1934, as amended (the “Exchange Act”)), as of the end of the period covered by this Quarterly Report on Form 10-Q. The term “disclosure controls and procedures” means our controls and other procedures that are designed to ensure that information required to be disclosed by us in the reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC rules and forms, 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.

Based on the foregoing evaluation, our Chief Executive Officer and Chief Financial Officer have concluded that, as of June 30, 2018, due to the existence of unremediated material weaknesses in the Company's internal control over financial reporting as described below, the Company's disclosure controls and procedures were not effective.

Notwithstanding the existence of the material weaknesses described below, management believes that the consolidated financial statements and related financial information included in this Quarterly Report on Form 10-Q fairly present, in all material respects, our financial position, results of operations and cash flows as of and for the periods presented, in conformity with the

Table of Contents

generally accepted accounting principles (“GAAP”) in the United States of America. Management’s belief is based on a number of factors, including, but not limited to:

- a) the completion of the Audit Committee’s investigation and the substantial resources expended (including the use of external consultants and experts) to respond to the findings and the resulting restatement of certain of our previously issued financial statements; the Audit Committee engaged independent professionals to assist its investigation throughout the process and, the Audit Committee has concluded its investigation;
- b) our internal review that identified certain accounting errors and control deficiencies, leading to the restatement of certain of our previously issued financial statements for the quarterly periods ended June 30, 2016, September 30, 2016, financial year ended December 31, 2016, and the quarterly periods ended March 31, 2017, June 30, 2017 and September 30, 2017;
- c) based on the efforts in (a) and (b) above, we have updated, and in some cases corrected, our accounting policies and have applied these to our previously issued financial results and to our fiscal year 2016 and 2017 financial results; and
- d) certain remediation actions we have undertaken to address the identified material weaknesses, as discussed below.

Management's Report on Internal Control over Financial Reporting.

Our management is responsible for establishing and maintaining adequate internal control over financial reporting as defined in Rule 13a-15(f) and 15d-15(f) of the Exchange Act. Our internal control over financial reporting is a process designed by, or under the supervision of, our Chief Executive Officer and Chief Financial Officer, and overseen by our Board of Directors (the “Board”), management and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with GAAP. Internal control over financial reporting includes those policies and procedures that: (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of our assets; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with GAAP, and that receipts and expenditures are being made only in accordance with authorizations of our management and directors; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of our assets that could have a material effect on our financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of the effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies and procedures included in such controls may deteriorate.

Our management has assessed the effectiveness of our internal control over financial reporting as of June 30, 2018. In making this assessment, management used the criteria established by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in Internal Control-Integrated Framework (2013). A material weakness is a deficiency, or combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the Company’s annual or interim financial statements will not be prevented or detected on a timely basis. Based on the results of that evaluation, which included information identified during the Audit Committee investigation and the work undertaken by management and the Company's advisors, management has concluded that our internal control over financial reporting as of June 30, 2018 was not effective due to the existence of the following material weaknesses in internal control over financial reporting described below.

Control Environment, Risk Assessment, Control Activities and Monitoring

Based on the investigations conducted under the direction of the Audit Committee of the Board, it was concluded that there was an inadequate open flow, transparency, communication and dissemination of relevant and pertinent information from former senior management concerning a complex transaction with the federal government that

contributed to an ineffective control environment driven by the tone at the top. Management's failure to timely communicate all pertinent information resulted in an environment which led to an error in the financial statement as of the end of the period covered by this report.

In addition, we did not maintain effective internal control over financial reporting related to the following areas: control environment, risk assessment, control activities and monitoring:

We did not have processes and controls to ensure there were adequate mechanisms and oversight to ensure accountability for the performance of internal control over financial reporting responsibilities and to ensure corrective actions were appropriately prioritized and implemented in a timely manner.

Table of Contents

• We did not effectively execute a strategy to attract, develop and retain a sufficient complement of qualified resources with an appropriate level of knowledge, experience, and training in certain areas important to financial reporting.

• There was not an adequate assessment of changes in risks by management that could significantly impact internal control over financial reporting or an adequate determination and prioritization of how those risks should be managed.

• We did not have adequate management oversight of accounting and financial reporting activities in implementing certain accounting practices to conform to the Company's policies and GAAP.

• We did not have adequate management oversight around completeness and accuracy of data material to financial reporting.

• There was a lack of robust, established and documented accounting policies and insufficiently detailed Company procedures to put these policies into effective action.

We were not focused on a commitment to competency as it relates to creating priorities, allocating adequate resources and establishing cross functional procedures around managing complex contracts and non-routine transactions as well as managing change and attracting, developing and retaining qualified resources.

These deficiencies in our internal control over financial reporting contributed to the following identified material weaknesses:

A. Accounting Close and Financial Reporting

We had inadequate or ineffective process level and monitoring controls in the area of accounting close and financial reporting specifically, but not exclusively, around the review of account reconciliations, account estimates and related cut-off, and monitoring of the accounting close cycle. We also did not have effective business processes and controls to conduct an effective review of manual data feeds into journal entries for divisions which were not integrated with the main ERP system.

We did not have robust, established and documented accounting policies that were implemented effectively, which led to adjustments in areas such as, but not exclusive to Impairment of Internally Developed Software (IDS) and Unclaimed Liability. As a result of these adjustments the accounts related to Amortization of IDS, Fixed Assets, and operating expenses as they relate to interest and penalties were impacted.

We also did not have a robust process around managing change and corresponding assessment and implementation of Accounting Policies. This resulted in a reevaluation of the Accounts Receivable and Customer Obligation Offset Policy of the organization. Furthermore, it also resulted in the delayed assessment and design of controls for the timely implementation of controls around Accounting Standard 606 (ASC 606) for Revenue Recognition which is effective January 2018. These gaps resulted in several adjustments in the consolidated financial statements as of the end of the period covered by this report.

B. Contract to Cash
Process

We did not have effective controls around our contract-to-cash life cycle. The root cause of these gaps were due to inadequate or ineffective process level controls around billing set-up during customer implementation, managing change to existing customer billing terms and conditions, timely termination of customers, implementing complex and/or non-standard billing arrangements which require manual intervention or manual controls for billing to customers, processing timely adjustments, lack of robust, established and documented policies to assess collectability and reserve for revenue, bad debts and accounts receivable, and availability of customer contracts.

These gaps resulted in several adjustments in Revenue, Accounts Receivable, and Accounts Receivable Reserves in the consolidated financial statements as of the end of the period covered by this report.

C. Risk Assessment and Management of Change

We did not maintain an effective risk assessment and monitoring process to manage the expansion of our existing business. Hence, there were inadequate and ineffective business and financial reporting control activities associated with change

37

Table of Contents

and growth in the business. Amongst other areas, the assessment of the control environment and the design of manual controls around financial system implementations, such as NetSuite, was not performed adequately in 2017.

As a result, the Company did not properly estimate and record certain transactions which resulted in errors in the consolidated financial statements as of the end of the period covered by this report.

D. Review of New, Unusual or Significant Transactions and Contracts

We did not have adequate risk assessment controls to continuously formally assess the financial reporting risks associated with executing new, significant or unusual transactions, contracts or business initiatives. As a result, the Company did not adequately identify and analyze changes in the business and hence implement effective process level controls and monitoring controls that were responsive to these changes and aligned with financial reporting objectives. This failure to identify and analyze changes occurred in connection with the integration of acquisitions and the monitoring and recording of certain revenues associated with a complex government contract. As a result, the Company did not properly account for certain transactions including Revenue and Customer Obligation Accounts, which resulted in errors in the consolidated financial statements as of the end of the period covered by this report.

E. Manual Reconciliations of High-Volume Standard Transactions

We did not have effective business processes and controls as well as resources with adequate training and support to conduct an effective review of manual reconciliations including the complex data feeds into the reconciliations of high-volume standard transactions. This resulted in several errors mainly to balance sheet classifications around Accounts Receivable, Customer Obligations and other related accounts in the consolidated financial statements as of the end of the period covered by this report.

In addition to the material weaknesses noted above, management identified several deficiencies and significant deficiencies. These deficiencies relate to several areas that are partially rooted in the weaknesses in the internal control environment documented above.

Remediation Plan and Status for Reported Material Weaknesses

We have been working and are currently working to remediate the material weaknesses described above, including assessing the need for additional remediation steps and implementing additional measures to remediate the underlying causes that gave rise to the material weaknesses. The Company is committed to a strong internal control environment and to ensure that a proper, consistent tone is communicated throughout the organization, including the expectation that previously existing deficiencies will be remediated through implementation of processes and controls to ensure strict compliance with GAAP and the 2013 COSO framework.

To address the material weaknesses in the overall control environment, in addition to the specific remediations noted under each sub-section, the Company has and is in the process of taking the following measures:

• The Company has undergone a leadership transition, and we have a new CEO, CFO and General Counsel. Clear lines of responsibilities have been drawn in new roles to ensure effective controls.

• We are establishing regular working group meetings, with appropriate oversight by the Audit Committee and leadership of the Company, to strengthen accountability for performance of internal control over financial reporting responsibilities and prioritization of corrective actions.

• We will be enhancing our compensation practices to further incorporate risk and operational goals.

• We will be assessing and enhancing adequacy and quality of resources in areas impacting financial reporting including, but not limited to conducting additional training programs for our employees to enhance their skill sets

which will complement their work.

- We are augmenting accounting staff with additional technical expertise in GAAP to assist with enhanced financial reporting procedures, controls and remediation efforts.

To address the material weakness in the Accounting Close and Financial Reporting area (Material Weakness A., noted above), the Company has taken the following measures:

38

Table of Contents

We are establishing senior level oversight and executive reporting around the accounting close and financial reporting process with an enhanced focus on improving process level controls to strengthen the existing control environment around formalizing and documenting accounting policies as well as implementing a robust accounting close process with enhanced review of financial statements.

In addition to enhancing processes and controls over adoption of new accounting standards, we will also be enhancing GAAP expertise within the accounting department.

To address the material weakness in the Contract to Cash Process (Material Weakness B., noted above), the Company has taken the following measures:

We are establishing senior level oversight and executive reporting around the contract to cash process with an enhanced focus on improving process level controls to strengthen the existing control environment around the contract to cash process and revenue recognition. This includes but is not limited to enhancing the process for record retention of contracts and agreements, assessment of collectability from customers, analysis of complex contracts as well as automation of select billing processes.

To address the material weakness in the Risk Assessment and Change Management Process (Material Weakness C., noted above), the Company has taken the following measures:

We are developing a plan to implement a periodic risk assessment process, review of control procedures and documentation around impact of changes on accounting processes.

We are developing a plan to enhance documentation and review around accounting estimates, and interpretations with formal approval of the detailed review.

We are developing a plan to proactively design manual controls around implementation of new systems impacting financial reporting.

We have reallocated Company resources to improve the oversight over operational changes across the business and business trends.

To address the material weakness in the Review of New, Unusual or Significant Transactions and Contracts (Material Weakness D., noted above), the Company is in process of strengthening its processes and controls as follows:

We are designing and implementing enhanced internal controls surrounding identification, analysis and governance and monitoring of new, significant or unusual contracts or transactions to ensure that these contracts or transactions are recorded in accordance with Company's policies and GAAP. This will entail enhanced documentation of analysis, as well as review and cross functional approval of company policies and interpretations.

To address the material weakness in the Manual Reconciliations of High-Volume Standard Transactions (Material Weakness E, noted above), the Company has taken the following measures:

We are providing leadership oversight to ensure prioritization of funding and resources for the remediation efforts.

We are strengthening the review controls and supporting documentation related to reconciliations of high-volume standard transactions. With an enhanced focus on supporting documentation review, we are implementing a comprehensive review methodology over data, inputs and reports used for the reconciliations.

The material weaknesses will not be considered remediated until the applicable remedial controls operate for a sufficient period of time and management has concluded, through testing, that these controls are operating effectively. Additional remediation measures may be required, which may require additional implementation time. We will continue to assess the effectiveness of our remediation efforts in connection with our evaluations of internal control over financial reporting.

Table of Contents

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

Information with respect to this Item may be found under the heading “Legal Matters” in Note 14 to the Condensed Consolidated Financial Statements in this Quarterly Report on Form 10-Q, which is incorporated into this Item 1 by reference.

Item 1A. Risk Factors

There have been no material changes in our risk factors disclosed in Part I, Item 1A, “Risk Factors”, of our Annual Report on Form 10-K for the year ended December 31, 2017.

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

Stock Repurchases

None

Item 4. Mine Safety Disclosures

Not Applicable

Item 5. Other Information

None

Table of Contents

Item 6. Exhibits

Exhibit No.	Exhibit Description	Incorporated by Reference		Filed Herewith
		FormFile No.	Exhibit Filing Date	
31.1	<u>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</u>			X
31.2	<u>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</u>			X
32.1 ⁽¹⁾	<u>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</u>			X
10.1	<u>Third Amended and Restated Employment Agreement between Registrant and Joseph Jackson dated April 18, 2017</u>	8-K 001-35232	10.1 4/21/2017	
10.2	<u>Form of Amended and Restated Executive Severance Benefit Agreement</u>	8-K 001-35232	10.2 4/21/2017	
10.10H	<u>Second Amended and Restated Credit Agreement, by and among Registrant, MUFG Union Bank, N.A. (formerly Union Bank, N.A.), Wells Fargo Bank National Association, Suntrust Bank, UMB Bank, N.A., KeyBank National Association, and Comerica Bank dated June 5, 2015</u>	10-Q 001-35232	10.10H8/1/2017	
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			

The certifications attached as Exhibit 32.1 that accompany this Quarterly Report on Form 10-Q are not deemed filed with the Securities and Exchange Commission and are not to be incorporated by reference into any filing of (1) WageWorks, Inc. under the Securities Act of 1933, as amended, or the Securities Exchange Act of 1934, as amended, whether made before or after the date of this Form 10-Q, irrespective of any general incorporation language contained in such filing.

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.

WAGWORKS, INC.

Date: March 18, 2019 By: /s/ ISMAIL DAWOOD

Ismail Dawood

Chief Financial Officer

(Principal Financial and Accounting Officer)