

WAGWORKS, INC.  
Form 10-Q  
November 05, 2013  
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**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 September 30, 2013**

**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**

**WAGWORKS, INC.**

**(Exact name of Registrant as specified in its charter)**

<b>Delaware</b> <b>(State or other jurisdiction of</b>	<b>94-3351864</b> <b>(I.R.S. Employer</b>
<b>incorporation or organization)</b>	<b>Identification No.)</b>
<b>1100 Park Place, 4th Floor</b>	
<b>San Mateo, California</b> <b>(Address of principal executive offices)</b>	<b>94403</b> <b>(Zip Code)</b>
<b>(650) 577-5200</b>	
<b>(Registrant's telephone number, including area code)</b>	

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

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

Large accelerated filer  Accelerated filer   
Non-accelerated filer  (Do not check if a smaller reporting company) Smaller reporting company   
Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes  No

As of October 30, 2013, there were 34,594,482 shares of the registrant's common stock outstanding.

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**WAGWORKS, INC.  
FORM 10-Q QUARTERLY REPORT**

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**Table of Contents****PART I. FINANCIAL INFORMATION****Item 1. Financial Statements****WAGWORKS, INC.****Consolidated Balance Sheets****(In thousands, except per share amounts)**

	<b>December 31, 2012</b>	<b>September 30, 2013 (unaudited)</b>
<b>Assets</b>		
Current assets:		
Cash and cash equivalents	\$ 305,052	\$ 309,094
Restricted cash	1,147	331
Accounts receivable, net	22,924	30,711
Deferred tax assets - current	11,855	1,985
Prepaid expenses and other current assets	6,309	7,642
<b>Total current assets</b>	<b>347,287</b>	<b>349,763</b>
Restricted cash, net of current portion	2,432	
Property and equipment, net	24,777	26,545
Goodwill	94,827	98,089
Acquired intangible assets, net	47,506	44,609
Deferred tax assets		9,870
Other assets	1,938	16,630
<b>Total assets</b>	<b>\$ 518,767</b>	<b>\$ 545,506</b>
<b>Liabilities and Stockholders Equity</b>		
Current liabilities:		
Accounts payable and accrued expenses	\$ 42,034	\$ 46,005
Customer obligations	249,801	242,567
Short-term contingent payment	6,818	4,790
Other current liabilities	2,726	727
<b>Total current liabilities</b>	<b>301,379</b>	<b>294,089</b>
Long-term debt	44,371	29,428
Long-term contingent payment, net of current portion	11,772	5,695
Deferred tax liability	2,450	1,485
Other non-current liability	2,384	1,824
<b>Total liabilities</b>	<b>362,356</b>	<b>332,521</b>

Stockholders Equity:

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Common stock, \$0.001 par value. Authorized 1,000,000 shares; issued 31,771 shares at December 31, 2012 and 34,758 shares at September 30, 2013	32	35
Treasury stock at cost 200 shares at December 31, 2012 and September 30, 2013	(546)	(546)
Additional paid-in capital	221,046	261,238
Accumulated deficit	(64,121)	(47,742)
<b>Total stockholders equity</b>	<b>156,411</b>	<b>212,985</b>
<b>Total liabilities and stockholders equity</b>	<b>\$ 518,767</b>	<b>\$ 545,506</b>

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

**Table of Contents****WAGeworks, INC.****Consolidated Statements of Income****(In thousands, except per share amounts)****(Unaudited)**

	<b>Three Months Ended September 30,</b>		<b>Three Months Ended September 30,</b>	
	<b>2012</b>	<b>2013</b>	<b>2012</b>	<b>2013</b>
<b>Revenues:</b>				
Healthcare	\$ 26,508	\$ 32,646	\$ 83,353	\$ 102,244
Commuter	13,090	14,949	38,302	44,378
Other	2,940	5,976	8,970	17,625
<b>Total revenue</b>	<b>42,538</b>	<b>53,571</b>	<b>130,625</b>	<b>164,247</b>
<b>Operating expenses:</b>				
Cost of revenues (excluding amortization of internal use software)	15,210	19,300	47,887	59,845
Technology and development	4,784	4,934	13,746	16,501
Sales and marketing	6,901	8,713	21,377	25,637
General and administrative	6,950	10,185	21,753	28,402
Amortization and change in contingent consideration	3,713	554	12,245	9,741
<b>Total operating expenses</b>	<b>37,558</b>	<b>43,686</b>	<b>117,008</b>	<b>140,126</b>
<b>Income from operations</b>	<b>4,980</b>	<b>9,885</b>	<b>13,617</b>	<b>24,121</b>
<b>Other income (expense):</b>				
Interest income	14	3	33	16
Interest expense	(456)	(326)	(1,313)	(1,073)
Gain on revaluation of warrants			381	
Other income	19	7	46	40
<b>Income before income taxes</b>	<b>4,557</b>	<b>9,569</b>	<b>12,764</b>	<b>23,104</b>
Income tax provision	(2,034)	(1,818)	(5,007)	(6,725)
<b>Net income</b>	<b>2,523</b>	<b>7,751</b>	<b>7,757</b>	<b>16,379</b>
Accretion of redemption premium expense			(2,301)	
<b>Net income attributable to common stockholders</b>	<b>\$ 2,523</b>	<b>\$ 7,751</b>	<b>\$ 5,456</b>	<b>\$ 16,379</b>
	\$ 0.09	\$ 0.23	\$ 0.38	\$ 0.49

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Basic net income per share attributable to  
common stockholders

Diluted net income per share attributable to common stockholders	\$	0.08	\$	0.22	\$	0.21	\$	0.47
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Shares used in basic net income per share  
calculations

	26,755	34,134	14,235	33,285
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Shares used in diluted net income per share  
calculations

	31,632	35,875	24,411	34,929
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The accompanying notes are an integral part of the consolidated financial statements.



Table of Contents**WAGWORKS, INC.****Consolidated Statements of Cash Flows****(In thousands)****(Unaudited)**

	<b>Nine Months Ended September 30,</b>	
	<b>2012</b>	<b>2013</b>
<b>Cash flows from operating activities:</b>		
Net income	\$ 7,757	\$ 16,379
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	2,190	2,627
Amortization and change in contingent consideration	12,245	9,741
Stock-based compensation	2,855	6,476
Revaluation of warrants	(381)	
Loss on disposal of fixed assets	25	91
Payment of contingent consideration in excess of initial measurement	(3,361)	(643)
Provision for doubtful accounts	(412)	115
Deferred taxes	4,879	6,118
Excess tax benefit from the exercise of stock options		(7,084)
Changes in operating assets and liabilities:		
Accounts receivable	(3,313)	(7,156)
Prepaid expenses and other current assets	(2,381)	(2,084)
Other assets	(15)	308
Accounts payable and accrued expenses	4,050	4,310
Customer obligations	(18,891)	(11,044)
Other liabilities	317	(2,517)
Net cash provided by operating activities	5,564	15,637
<b>Cash flows from investing activities:</b>		
Purchases of property and equipment	(9,634)	(10,791)
Cash consideration for business acquisitions, net of cash acquired	8,551	(751)
Cash paid for acquisition of client contracts	(711)	(1,219)
Advance payment for acquisition of client contracts		(15,000)
Change in restricted cash	1,957	3,248
Net cash provided by (used in) investing activities	163	(24,513)
<b>Cash flows from financing activities:</b>		
Proceeds from debt	29,564	
Repayment of debt		(15,000)
	62,566	

Proceeds from initial public offering net of underwriters commissions and discounts		
Proceeds from follow-on offering net of underwriters commissions and discounts		11,550
Proceeds from exercise of common stock options	154	14,446
Proceeds from issuance of common stock (Employee Stock Purchase Plan)	451	1,467
Payment of contingent consideration	(14,110)	(6,629)
Purchase of treasury stock	(112)	
Excess tax benefit from the exercise of stock options		7,084
Net cash provided by financing activities	78,513	12,918
Net increase in cash and cash equivalents	84,240	4,042
Cash and cash equivalents at beginning of period	154,621	305,052
<b>Cash and cash equivalents at end of period</b>	<b>\$ 238,861</b>	<b>\$ 309,094</b>

**Supplemental cash flow disclosure:**

Cash paid during the period for:

Interest	\$ 1,009	\$ 1,133
Taxes	575	557

**Noncash financing and investing activities:**

Accretion of redemption premium	2,301
Reduction in FBM contingent consideration due to re-negotiated lease	528
Conversion of preferred stock to common stock	118,417
Conversion of preferred stock warrants to common stock warrants	737

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

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**WAGeworks, INC.**

**Notes to Consolidated Financial Statements**

**(Unaudited)**

**(1) Summary of Business and Significant Accounting Policies**

***Business***

WageWorks, Inc., or the Company, is a leading on-demand provider of tax-advantaged programs for consumer-directed health, commuter and other employee spending account benefits, or CDBs, in the United States. The Company administers and operates a broad array of CDBs, including spending account management programs such as health and dependent care Flexible Spending Accounts, or FSAs, Health Savings Accounts, or HSAs, Health Reimbursement Arrangements, or HRAs, and commuter benefits, such as transit and parking programs.

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

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

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

***Follow-On Public Offerings***

On March 18, 2013, the Company closed a follow-on public offering and sold 500,000 shares of common stock at a price of \$24.00 per share, which raised \$11.6 million, net of underwriters' discounts and commissions. Certain selling stockholders, including funds affiliated with VantagePoint Capital Partners, or VantagePoint, sold 5,131,115 shares of common stock in the offering. In addition, the underwriters exercised their overallotment option to purchase 844,667 additional shares from the selling stockholders. The Company did not receive any proceeds from the sale of shares by the selling stockholders.

On August 19, 2013, the Company closed a follow-on public offering pursuant to which certain selling stockholders, including VantagePoint, sold 2,968,276 shares of common stock. In addition, the underwriters exercised their overallotment option to purchase 445,241 additional shares from the selling stockholders. The shares were purchased at a price of \$39.54 per share, net of underwriters' discounts and commissions. The Company did not receive any proceeds from the sale of shares by the selling stockholders.

***Unaudited Interim Financial Statements***

In the opinion of the Company's management, the unaudited interim consolidated financial statements have been prepared on the same basis as the audited consolidated financial statements and reflect all adjustments that, in the opinion of management, are necessary for a fair presentation of the results for the interim periods presented in accordance with accounting principles generally accepted in the United States of America (GAAP). The results of the interim period presented herein are not necessarily indicative of the results of future periods or annual results for the year ended December 31, 2013.

These unaudited interim consolidated financial statements should be read in conjunction with the December 31, 2012 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, 2012 consolidated balance sheet included in this interim Quarterly Report on Form 10-Q was derived from audited financial statements.

There have been no changes in the Company's significant accounting policies from those that were disclosed in the Company's audited consolidated financial statements for the fiscal year ended December 31, 2012 included in the Company's Annual Report on Form 10-K.

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**WAGeworks, INC.**

**Notes to Consolidated Financial Statements**

**(Unaudited)**

***Principles of Consolidation***

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

***Use of Estimates***

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

***Fair Value of Financial Instruments***

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

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

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

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

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

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

Other financial instruments not measured at fair value on the Company's unaudited consolidated balance sheet at September 30, 2013, but which require disclosure of their fair values include: cash and cash equivalents (including restricted cash), accounts receivable, accounts payable and accrued expenses and debt under the line of credit with Union Bank, N.A. The estimated fair value of such instruments at September 30, 2013 approximates their carrying value as reported on the consolidated balance sheet. The fair value of all of these instruments are categorized as Level 2 of the fair value hierarchy, with the exception of cash, which is categorized as Level 1.

Table of Contents**WAGeworks, INC.****Notes to Consolidated Financial Statements****(Unaudited)**

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

	<b>Contingent Consideration FBM</b>	<b>Contingent Consideration CS</b>	<b>Contingent Consideration BCI</b>	<b>Contingent Consideration CBS</b>
Balances at December 31, 2012	\$ 330	\$ 6,488	\$ 11,772	\$
Initial fair value of contingent consideration				2,170
Gains or losses included in earnings:				
(Gains) losses on revaluation of contingent consideration	(330)	784	(3,517)	60
Payment of contingent consideration		(7,272)		
Balances at September 30, 2013	\$	\$	\$ 8,255	\$ 2,230

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

The Company recorded less than ten thousand dollars and \$1.6 million in charges related to the change in fair value of the contingent considerations for Planned Benefits Systems and FBM, respectively, during each of the three and nine months ended September 30, 2012, due to increased revenue levels estimated to be achieved. In the three and nine months ended September 30, 2012, the Company recorded \$0.2 million and \$1.1 million in charges, respectively, related to the change in fair value of the CS contingent consideration due to increased revenue levels estimated to be achieved. In the three and nine months ended September 30, 2012, the Company recorded less than a \$0.1 million and \$0.1 million in charges, respectively, related to the change in fair value of the TransitCheck contingent consideration as a result of the passage of time.

During the three months ended September 30, 2013, the Company recorded a net gain of \$3.8 million for CS, BCI and CBS related to changes in fair value of the contingent considerations. The gain was driven by the re-measurement of the contingent consideration related to BCI, as the timing of anticipated partnerships and employer clients were deferred until later in 2014 and into 2015, as such the anticipated revenue increase in 2014 and 2015 was adjusted in the forecasts. During the nine months ended September 30, 2013, the Company recorded a net gain of \$3.0 million for FBM, CS, BCI and CBS related to changes in fair value of the contingent consideration, driven by BCI as discussed above for the three months ended September 30, 2013.

*Quantitative Information About Level 3 Fair Value Measurements*

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

	<b>Fair Value at September 30, 2013</b>	<b>Valuation Technique</b>	<b>Significant Unobservable Input</b>
<b>(in thousands, unaudited)</b>			
Contingent consideration - BCI	\$ 8,255	Discounted cash flow	Annualized revenue and probability of achievement
Contingent consideration - CBS	\$ 2,230	Discounted cash flow	Annualized revenue and probability of achievement

*Sensitivity to Changes in Significant Unobservable Inputs*

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



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**WAGEWORKS, INC.**

**Notes to Consolidated Financial Statements**

**(Unaudited)**

***Recently Issued Accounting Pronouncements***

In July 2013, the FASB issued Accounting Standards Update No. 2013-11, Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or Tax Credit Carryforward Exists, ( ASU 2013-11 ). ASU 2013-11 requires entities to present an unrecognized tax benefit, or a portion of an unrecognized tax benefit, as a reduction to a deferred tax asset for a net operating loss carryforward, a similar tax loss, or a tax credit carryforward when settlement in this manner is available under the tax law. The Company does not anticipate that the adoption of this standard in the first quarter of 2015 will have a material impact on its results of operations or its financial condition.

Table of Contents**WAGEWORKS, INC.****Notes to Consolidated Financial Statements****(Unaudited)****(2) Net Income per Share**

The following table sets forth the computation of basic and diluted net income per share attributable to Common Stockholders:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2013	2012	2013
<b>Numerator (basic and diluted):</b>				
Net income	\$ 2,523	\$ 7,751	\$ 7,757	\$ 16,379
Less: accretion of redemption premium expense			(2,301)	
Net income attributable to common stockholders for basic EPS	\$ 2,523	\$ 7,751	\$ 5,456	\$ 16,379
Add back: accretion of redemption premium related to dilutive redeemable preferred stock			(260)	
Net income attributable to common stockholders for diluted EPS	\$ 2,523	\$ 7,751	\$ 5,196	\$ 16,379
<b>Denominator (basic):</b>				
Weighted average common shares outstanding	26,755	34,134	14,235	33,285
<b>Denominator (diluted):</b>				
Weighted average common shares outstanding	26,755	34,134	14,235	33,285
Dilutive stock options	1,620	1,741	1,280	1,644
Weighted average common shares from stock warrants	3,257		2,891	
Weighted average common shares from preferred stock			6,005	
Net weighted average common shares outstanding	31,632	35,875	24,411	34,929

Net income per share attributable to holders of common stock:								
Basic	\$	0.09	\$	0.23	\$	0.38	\$	0.49
Diluted	\$	0.08	\$	0.22	\$	0.21	\$	0.47

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

	Three Months Ended September 30, 2012		Nine Months Ended September 30, 2013	
Stock options outstanding	1	4	40	29
Common shares from convertible preferred stock			2,774	
Total common stock equivalents	1	4	2,814	29

**Table of Contents****WAGEWORKS, INC.****Notes to Consolidated Financial Statements****(Unaudited)****(3) Acquisitions***Crosby Benefit Systems, Inc. Acquisition*

On May 1, 2013, the Company acquired Crosby Benefit Systems, Inc., or CBS, a third party administrator of tax-advantaged consumer directed benefits, such as, flexible spending accounts, health reimbursement arrangements, COBRA continuance services, enrollment and eligibility management and commuter programs, based in Newton, Massachusetts. CBS will continue to operate out of the Newton office as a division of the Company. The Company accounted for the acquisition of CBS as a purchase of a business under ASC 805. The results of operations for CBS have been included in the Company's financial results since the acquisition date. The goodwill of \$3.3 million arising from the acquisition was attributed to the premium paid for the opportunity to expand and better serve small and medium-sized businesses as well as enterprise clients. Goodwill is also attributed to the expectation of achieving greater long-term growth as a combined company than either company had operating alone. This acquisition added new customers and participant relationships and further strengthens the Company's position in the Consumer-Directed Benefits market. The aggregate non-contingent portion of the purchase price was \$5.0 million and was paid in cash on May 1, 2013.

The purchase price also includes a contingent consideration element that requires the Company to pay the former owners of CBS additional amounts in 2014 and 2015 based upon revenue growth rates of CBS for 2014 and 2015, respectively. The initial fair value of the contingent element totaled \$2.2 million based on forecasted revenue growth rates for 2014 and 2015. The fair value was determined from forecasts developed by management based upon existing business and relationships and projected growth rates. The Company discounted these forecasts using a present value discount factor of 6.5%. As the fair value measure is based on significant inputs that are not observable in the market, the Company categorizes the inputs as Level 3 inputs under ASC 820.

The following table summarizes the consideration for CBS and the amounts of estimated fair value of the assets acquired and liabilities assumed at the acquisition date (dollars in millions):

Goodwill	\$ 3.3
Customer relationships	2.7
Other intangibles	0.1
Other net assets acquired	1.1
<b>Total allocation of purchase price</b>	<b>\$ 7.2</b>

Customer relationships are being amortized over a useful life of 8 years.

Goodwill was calculated as the difference between the acquisition-date fair value of the consideration transferred and the provisional values assigned to the assets acquired and liabilities assumed. None of the goodwill is expected to be

deductible for tax purposes.

*Benefit Concepts, Inc. Acquisition*

On December 31, 2012, the Company acquired Benefit Concepts, Inc., or BCI, a third party administrator of Consumer-Directed Benefits, such as, Flexible Spending Accounts, Health Reimbursement Arrangements and COBRA benefits continuation services based in East Providence, Rhode Island. The Company accounted for the acquisition of BCI as a purchase of a business under ASC 805.

The valuation of acquired payments to or from participants of BCI remain provisional and are based on the information that was available as of the acquisition date to estimate the fair value of these assets acquired and liabilities assumed. The Company believes that information provides a reasonable basis for estimating the fair value but the Company is waiting for additional information necessary to finalize those amounts. Thus, the provisional measurements of fair value reflected are subject to change. Such changes could be significant. The Company expects to finalize the valuation and complete the purchase price allocation as soon as practicable but no later than one year from the acquisition date.

Table of Contents**WAGWORKS, INC.****Notes to Consolidated Financial Statements****(Unaudited)***Aflac Channel Partner Arrangement*

In April 2012, the Company entered into a channel partner arrangement with American Family Life Assurance Company, or Aflac, pursuant to which Aflac's FSA and commuter account administration business would be transitioned to the Company. As of June 30, 2013, the transitioning of existing Aflac employer clients was completed. The Company paid Aflac total payments of \$7.2 million for all employer clients that transitioned to the Company. The Company has capitalized these payments as an intangible asset and is amortizing the asset over an expected life of 7 years.

*Ceridian Channel Partner Arrangement*

In July 2013, the Company entered into a channel partner arrangement with Ceridian, a global product and services company, pursuant to which the Ceridian's Consumer-Directed Benefit account administration business will be substantially transitioned to the Company between October 2013 and January 2015. This new channel partner arrangement will not have a significant impact on revenue in 2013. In conjunction with the transition, the Company also entered into a separate reseller arrangement with Ceridian.

The final purchase price is calculated as a multiple of the expected annual revenue for each employer client successfully transitioned to the Company. The timing of the transition of revenue to the Company is dependent upon the employer clients executing new agreements with the Company and agreeing to a service conversion, a process whose timing and outcome is ultimately controlled by each employer client. In July 2013, the Company made an initial payment of \$15.0 million to Ceridian, in advance of any employer clients transitioning over to the Company, which is anticipated to cover a substantial portion of the purchase price. The \$15.0 million payment was recorded in the other assets line item in the Company's consolidated balance sheet as of September 30, 2013. As the employer clients transition to the Company, the payments will be transferred to intangible assets and amortized over the expected life of the relationship with the employer client. The Company will incur certain one-time transition costs but the amount and timing of such costs remain uncertain until the Company and Ceridian have finalized the transition schedule.

**(4) Goodwill and Intangible Assets**

The change in the carrying amount of goodwill from the year ended December 31, 2012 to September 30, 2013 is as follows (dollars in thousands):

Balance at December 31, 2012	\$ 94,827
Additions	3,262

Balance at September 30, 2013	\$ 98,089
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The increase in goodwill is attributed to the acquisition of CBS (see Note 3).

**Table of Contents****WAGEWORKS, INC.****Notes to Consolidated Financial Statements****(Unaudited)**

Acquired intangible assets at December 31, 2012 and September 30, 2013 were comprised of the following (dollars in thousands):

	December 31, 2012			September 30, 2013		
	Gross carrying amount	Accumulated amortization	Net	Gross carrying amount	Accumulated amortization	Net
<b>Amortizable intangible assets:</b>						
Client contracts and broker relationships	\$ 58,410	\$ 19,273	\$ 39,137	\$ 62,336	\$ 23,852	\$ 38,484
Trade names	2,180	792	1,388	2,240	1,036	1,204
Technology	9,946	4,316	5,630	9,946	6,256	3,690
Noncompete agreements	2,012	1,705	307	2,012	1,735	277
Favorable lease	1,137	93	1,044	1,137	183	954
<b>Total</b>	<b>\$ 73,685</b>	<b>\$ 26,179</b>	<b>\$ 47,506</b>	<b>\$ 77,671</b>	<b>\$ 33,062</b>	<b>\$ 44,609</b>

Amortization expense for acquired intangible assets totaled \$1.7 million and \$2.3 million for the three months ended September 30, 2012 and 2013, respectively. Amortization expense for acquired intangible assets totaled \$4.7 million and \$6.9 million for the nine months ended September 30, 2012 and 2013, respectively.

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

Remainder of 2013	\$ 2,168
2014	8,478
2015	6,983
2016	5,907
2017	5,580
Thereafter	15,493
<b>Total</b>	<b>\$ 44,609</b>

**(5) Accounts Receivable**

Accounts receivable at December 31, 2012 and September 30, 2013 were comprised of the following (dollars in thousands):



	<b>December 31, 2012</b>	<b>September 30, 2013</b>
Trade receivables	\$ 14,965	\$ 17,365
Unpaid amounts for benefit services	8,362	14,076
	23,327	31,441
Less allowance for doubtful accounts	(403)	(730)
Accounts receivable, net	\$ 22,924	\$ 30,711

Table of Contents**WAGEWORKS, INC.****Notes to Consolidated Financial Statements****(Unaudited)****(6) Property and Equipment**

Property and equipment at December 31, 2012 and September 30, 2013 were comprised of the following (dollars in thousands):

	<b>December 31, 2012</b>	<b>September 30, 2013</b>
Computers and equipment	\$ 10,877	\$ 10,721
Software and development costs	54,274	61,988
Furniture and fixtures	3,291	2,818
Leasehold improvements	7,039	5,841
	<b>\$ 75,481</b>	<b>\$ 81,368</b>
Less accumulated depreciation and amortization	(50,704)	(54,823)
<b>Property and equipment, net</b>	<b>\$ 24,777</b>	<b>\$ 26,545</b>

In the nine months ended September 30, 2013, the Company capitalized software development costs of \$8.8 million. In the three months ended September 30, 2012 and 2013, the Company amortized \$1.8 million and \$2.0 million of capitalized software development costs, respectively. In the nine months ended September 30, 2012 and 2013, the Company amortized \$4.8 million and \$5.8 million of capitalized software development costs, respectively. These costs are included in amortization and change in contingent consideration in the accompanying consolidated statements of income. At September 30, 2013, the unamortized software development costs included in property and equipment in the accompanying consolidated balance sheet was \$20.6 million.

Total depreciation expense, including amortization of capitalized software development costs, in the three months ended September 30, 2012 and 2013 was \$2.5 million and \$2.8 million, respectively, and \$7.0 million and \$8.5 million in the nine months ended September 30, 2012 and 2013, respectively.

**(7) Accounts Payable and Accrued Expenses**

Accounts payable and accrued expenses at December 31, 2012 and September 30, 2013 were comprised of the following (dollars in thousands):

<b>December 31, 2012</b>	<b>September 30, 2013</b>
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Accounts payable	\$ 2,020	\$ 1,141
Payable to benefit providers and transit agencies	17,519	22,242
Accrued payables	6,239	5,879
Accrued compensation and related benefits	12,153	11,667
Other accrued expenses	1,994	1,947
Deferred revenue	2,109	3,129
Accounts payable and accrued expenses	\$ 42,034	\$ 46,005

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**WAGWORKS, INC.**

**Notes to Consolidated Financial Statements**

**(Unaudited)**

**(8) Debt**

Debt consists of borrowings under a Commercial Credit Agreement, or Revolver, with Union Bank, N.A., or UB, under which the Company can borrow an aggregate principal amount up to \$75.0 million. In the third quarter of 2013, the Company repaid \$15.0 million and as of September 30, 2013 had \$29.6 million outstanding under the Revolver with UB.

**(9) Common Stock**

Funds affiliated with VantagePoint owned approximately 11% of the Company's outstanding common stock at September 30, 2013. The stockholder agreement provides that VantagePoint has the right to select one of its board designees to serve on the Company's compensation committee, nominating and corporate governance committee and any other special committee of the Company's board of directors and has access to the Company's books and records, so long as it continues to hold at least 10% of the Company's outstanding shares. Additionally, so long as VantagePoint holds any of the Company's shares, the Company may not amend any provision of our certificate of incorporation or bylaws relating to VantagePoint's rights without VantagePoint's consent. Certain corporate actions by the Company no longer require VantagePoint's approval as their ownership percentage of the Company's outstanding common stock has fallen below 25%.

**(10) Employee Benefit Plans**

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

In fiscal 2010 and the first quarter of 2012, the Company granted a total of 418,500 and 320,000 performance option awards to certain executives of the Company, respectively. The performance option awards vest upon the completion of 7 years of service with the Company, and are subject to potential early vesting based upon the achievement of certain milestones as follows: 25% to vest upon an initial public offering, 25% to vest upon achieving certain revenue growth rate per year for two consecutive years, and an additional 50% will vest upon the achievement on an initial public offering and achieving consecutive growth rates. The Company completed its initial public offering in May 2012 and 25% of the awards have vested. At June 30, 2013, the Company anticipated that it was probable it will achieve revenue growth that would trigger early vesting of the awards and prospectively accelerated the stock-based compensation associated with these awards to be recognized through the end of fiscal 2013.

In the third quarter of 2012, the Company granted a total of 37,500 performance option award to an executive of the Company. The performance option award is subject to the following vesting criteria: none of the options shall vest until September 18, 2019, provided however, that the shares shall immediately vest and become exercisable upon the achievement of the following milestone: the shares shall immediately vest and become exercisable upon achieving

certain revenue growth rate per year for two consecutive years. At June 30, 2013, the Company anticipated that it was probable it will achieve revenue growth that would trigger early vesting of the awards and prospectively accelerated the stock-based compensation associated with these awards to be recognized through the end of fiscal 2013.

Table of Contents**WAGeworks, INC.****Notes to Consolidated Financial Statements****(Unaudited)**

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

	<b>Three Months Ended September 30,</b>		<b>Nine Months Ended September 30,</b>	
	<b>2012</b>	<b>2013</b>	<b>2012</b>	<b>2013</b>
Cost of revenue	\$ 68	\$ 316	\$ 219	\$ 713
Technology and development	84	224	221	566
Sales and marketing	75	303	298	790
General and administrative	954	2,075	2,117	4,407
<b>Total</b>	<b>\$ 1,181</b>	<b>\$ 2,918</b>	<b>\$ 2,855</b>	<b>\$ 6,476</b>

As of September 30, 2013, there was \$9.2 million of total unrecognized compensation cost related to unvested stock options which are expected to vest. The cost is expected to be recognized over a weighted average period of approximately 3.37 years as of September 30, 2013.

The following table summarizes the weighted-average fair value of stock options granted during the three and nine months ended September 30, 2012 and 2013:

	<b>Three Months Ended September 30,</b>		<b>Nine Months Ended September 30,</b>	
	<b>2012</b>	<b>2013</b>	<b>2012</b>	<b>2013</b>
Stock options granted (in thousands)	78	28	948	558
Weighted average fair value at date of grant	\$ 10.00	\$ 19.39	\$ 5.73	\$ 12.07

Stock option activity for the period ended September 30, 2013 is as follows (shares in thousands):

		<b>Weighted average</b>	<b>Remaining</b>	<b>Aggregate intrinsic</b>
	<b>Shares</b>	<b>exercise</b>	<b>contractual term</b>	<b>value (dollars</b>
		<b>price</b>	<b>(years)</b>	<b>in</b>
				<b>thousands)</b>
Outstanding at December 31, 2012	4,615	\$ 8.11	6.54	\$ 44,801
Granted	558	24.79		

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Exercised	(1,938)		7.45		
Forfeited	(67)		9.49		
Outstanding as of September 30, 2013	3,168	\$	11.41	6.76	\$ 123,662
Vested and expected to vest at September 30, 2013	3,052	\$	11.30	6.70	\$ 119,513
Exercisable at September 30, 2013	1,605	\$	8.63	5.21	\$ 67,129

Table of Contents**WAGWORKS, INC.****Notes to Consolidated Financial Statements****(Unaudited)**

The weighted average assumptions used in the Black-Scholes option pricing model to value option grants during the three and nine months ended September 30, 2012 and 2013 were as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2013	2012	2013
Expected volatility	52.36%	49.61%	52.83%	51.50%
Risk-free interest rate	1.23%	1.68%	1.27%	1.07%
Expected term (in years)	7.2	6.0	6.6	6.0
Dividend yield	%	%	%	%

The determination of the fair value of stock-based awards on the date of grant using an option pricing model is affected by the Company's stock price as well as assumptions regarding a number of complex and subjective variables. Expected volatility is determined using weighted average volatility of peer publicly traded companies. The risk-free interest rate is determined by using published zero coupon rates on treasury notes for each grant date given the expected life. The dividend yield of zero is based on the fact that the Company expects to invest cash in operations and has never paid cash dividends on Common Stock. The Company uses the simplified method to estimate expected term as determined under SAB 107 due to the lack of option exercise history as a public company.

***Restricted Stock Units***

The Company grants restricted stock units to certain employees, officers, and directors under the 2010 Plan. Restricted stock units vest upon either performance-based or service-based criteria. Generally, service-based restricted stock units vest over four years with 25% vesting after one year and the balance vesting monthly over the remaining period. Performance-based restricted stock units vest based on the satisfaction of specific performance criteria. At each vesting date, the holder of the award is issued shares of the Company's common stock. Compensation expense from these awards is equal to the fair market value of the Company's common stock on the date of grant and is recognized either over the requisite service period, for service-based awards, or based on the probable outcome of achievement of the financial metrics, for performance-based awards. Management's estimate of the number of shares expected to vest is based on the anticipated achievement of the specified performance criteria. No restricted stock units were granted prior to fiscal 2013.

In the first quarter of 2013, the Company granted a total of 195,000 performance-based restricted stock units to certain executives and employees and granted a total of 161,500 service-based restricted stock units to certain employees. Performance-based restricted stock units are typically granted such that they vest upon the achievement of specified financial metrics during a specified performance period for which participants have the ability to receive up to 150% of the target number of shares originally granted.

In the second quarter of 2013, the Company granted a total of 24,000 performance-based restricted stock units and a total of 5,000 service-based restricted stock units to certain employees. Performance-based restricted stock units are



typically granted such that they vest upon the achievement of specified financial metrics during a specified performance period for which participants have the ability to receive up to 150% of the target number of shares originally granted.

Stock-based compensation expense related to restricted stock units was \$1.0 million and \$1.9 million for the three and nine months ended September 30, 2013, respectively. As of September 30, 2013, there was \$9.4 million of total unrecognized compensation cost related to unvested restricted stock units which are expected to vest. The cost is expected to be recognized over a weighted average period of approximately 2.86 years as of September 30, 2013.

Table of Contents**WAGeworks, INC.****Notes to Consolidated Financial Statements****(Unaudited)**

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

	<b>Shares</b> <b>(in thousands)</b>	<b>Weighted Average</b> <b>Grant Date</b> <b>Fair Value</b>
Non-vested at December 31, 2012		\$
Granted	390,500	24.47
Vested		
Forfeitures		
Non-vested at September 30, 2013	390,500	\$ 24.47

**(11) Income Taxes**

The income tax provision for the three months ended September 30, 2012 and 2013 was \$2.0 million and \$1.8 million, respectively. The American Taxpayer Relief Act of 2012, or the Act, was enacted on January 2, 2013. The Act reinstated the research and development credit retroactively to January 1, 2012 and extended it through 2013. The change is primarily due to an increase of federal research and development tax credits under this retroactive reinstatement and estimated 2013 credits. The income tax provision for the nine months ended September 30, 2012 and 2013 was \$5.0 million and \$6.7 million, respectively. The change is primarily due to the increase in income before income taxes. The effective income tax rate for the three and nine months ended September 30, 2013 was impacted by an adjustment to the contingent consideration related to BCI, which is a non-taxable item. The Company provides for income taxes using an asset and liability approach, under which deferred income taxes are provided based upon enacted tax laws and rates applicable to periods in which the taxes become payable.

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

As of September 30, 2013, 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.



**Table of Contents****WAGEWORKS, INC.****Notes to Consolidated Financial Statements****(Unaudited)****(12) Commitments and Contingencies*****(a) Operating Leases***

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

	<b>Operating leases As of September 30, 2013</b>	
Remainder of 2013	\$	1,338
2014		4,873
2015		3,449
2016		1,724
2017		1,492
Thereafter		8,019
<b>Total future minimum lease payments</b>	<b>\$</b>	<b>20,895</b>

Rent expense was \$1.1 million for the three months ended September 30, 2012 and 2013, and \$3.4 million and \$3.7 million for the nine months ended September 30, 2012 and 2013, respectively.

***(b) Legal Matters***

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

**Table of Contents****Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations**

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

**Overview**

We are a leading on-demand provider of tax-advantaged programs for consumer-directed health, commuter and other employee spending account benefits, or CDBs, in the United States. We administer and operate a broad array of CDBs, including spending account management programs such as health and dependent care Flexible Spending Accounts, or FSAs, Health Savings Accounts, or HSAs, Health Reimbursement Arrangements, or HRAs, and commuter benefits, such as transit and parking programs.

Our company was founded in 2000 to provide the administration of tax-free commuter benefits. In early 2003, we expanded our business to include the administration of tax-advantaged healthcare programs with our FSA program. As a result of subsequent portfolio purchases made through 2006, we have broadened our CDB offerings to include HRA, HSA and Consolidated Omnibus Budget Reconciliation Act, or COBRA, programs. In 2007 we purchased MHM Resources, or MHM. The MHM small- and medium-sized business, or SMB, portfolio expanded our existing client base and the MHM technology platform enhanced our service offering to SMBs. Between 2008 and 2012, we made six portfolio purchases that have added to our client base and broadened our opportunities with employers of all sizes. We completed an acquisition in February 2012, entered into a channel partner arrangement in April 2012, made another portfolio purchase in May 2013 and entered another channel partner arrangement in July 2013.

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

These employee contributions result in savings to both employees and employers. As an example, based on our average employee participant's annual FSA contribution of approximately \$1,400 and an assumed personal combined federal and state income tax rate of 35%, an employee participant will reduce his or her taxes by approximately \$490 per year by participating in an FSA. Our employer clients also realize payroll tax (i.e., FICA and Medicare) savings on the pre-tax contributions made by their employees. In the above FSA example, an employer client would save approximately \$64 per participant per year, even after the payment of our fees.

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

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We market and sell our CDB programs through multiple channels, including direct sales to large enterprises, direct sales and through brokers to SMBs, direct sales to industry purchasing and affiliate groups and through channel partners. Our enterprise sales force targets Fortune 1000 companies and generates new large account relationships through employer prospecting, consultant relationships and strategic partnerships. Our SMB distribution channel complements our enterprise sales channel. It consists of third-party advisors and institutional brokers that sell our CDB programs along with their own complementary products to SMBs. Our average sales cycle ranges from approximately two months for SMBs to six to nine months for our large institutional clients.

Our CDB agreements with our larger employer clients, which we refer to as enterprise clients, are typically for three-year terms and provide for monthly fees based on the number of employee participants enrolled in our programs. We price our services 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. Almost all of the healthcare benefit plans we service on behalf of our enterprise clients are subject to contractual minimum monthly billing amounts. Generally, such minimum billing amounts are subject to upward revision on a monthly basis as our employer clients hire new employees who elect to participate in our programs, but generally are not subject to downward revision when employees leave their employers because we continue to administer those former employee participants' accounts for the remainder of the plan year. For our SMB clients, our agreements are typically for one to three year terms and the monthly fee remains constant for the plan year. In some cases, the agreements provide that the monthly fee is subject to upward revision when there is a 10% or greater increase in the number of employee participants during the plan year.

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

We offer prepaid debit cards for use in conjunction with almost all of the plans that we administer. These prepaid debit cards are offered in coordination with commercial banks and card associations. We receive interchange fees from employee participants' prepaid debit card transactions, which are calculated as a percentage of the expenses transacted on each card. The Durbin Amendment to the Electronic Funds Transfer Act, establishes rules that implement interchange transaction fee restrictions and prohibitions against payment card network exclusivity arrangements and transaction routing restrictions related to the processing of electronic debit transactions. Although the rules do not include an explicit exemption for health benefit cards, our interchange fees are exempt from the Durbin Amendment because there is an exception for general purpose reloadable prepaid cards and some of such cards also fall outside the definitions that establish the scope of coverage. In addition to interchange fees, we also derive revenue through our wholesale card program from fees we charge to assist third party administrators, or TPAs, in issuing our prepaid debit cards to their employee participant groups and in selling their administrative services utilizing our prepaid debit cards to new employee participants. We have historically experienced seasonality in healthcare interchange revenue, which is typically the highest during the first quarter of the year because participants

are either using their newly available balances for the current plan year or spending any remaining funds available from the prior plan year during the prior plan year's grace period. A grace period is generally established by employer clients as January 1 through March 15 of the succeeding plan year and is the period during which employee participants can access funds from the prior plan year's FSA account. Healthcare interchange revenue generally declines through the second and third quarters and is subject to a small increase in December as some employee participants strive to use their remaining account balances before the end of the plan year.

We also offer transit passes from various transit agencies, which we purchase on behalf of employee participants. Due to our significant volume, we receive commissions on these passes which we recognize as vendor commission revenue.

Our cost of revenues typically varies with our revenue and is, therefore, impacted by the seasonality of our business. We incur higher expenses in the first quarter associated with increased headcount in the form of temporary workers, consultants and other outsourced services that are required to cover the increased call volume and activity associated with the commencement of the new plan year. The need for these resources diminishes in the second and third quarters, but increases again in the fourth quarter when we provide services to our employer clients during their open enrollment periods. We also incur higher debit card production expenses in the fourth quarter.



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At the beginning of a plan year, most of our enterprise clients provide us with prefunds for their FSA programs based on a percentage of projected elections by the employee participants for the plan year ahead. This prefunding activity covers our estimate of approximately one week of spending on behalf of the employer client's employee participants. During the plan year, we process employee participants' FSA claims as they are submitted and typically seek reimbursement from our employer clients within one week after settling the claim. Employer clients generally set a time after the close of a plan year when employee participants in FSA programs are allowed to continue submitting claims for the preceding plan year, which we refer to as a run-out period. At the end of the plan year and following the grace period and run-out period, as applicable, we reconcile all claims paid against the FSA prefund and return any unused funds to the employer. Prior to that point we will have already received an entirely new FSA prefund from a continuing employer client for the new plan year.

Our growth strategy includes acquiring and integrating smaller TPAs to expand our employer client base. We refer to these acquisitions as portfolio purchases.

Consistent with this acquisition strategy, we have made seven portfolio purchases since 2007, which include MHM, in September 2007, Creative Benefits, or CB, in September 2008, Planned Benefit Systems, or PBS, in August 2010, the CDB assets of a division of Fringe Benefits Management Company or FBM, in November 2010, the assets of The Choice Care Card, LLC, also known as Choice Strategies, or CS, in January 2012, Benefit Concepts, Inc., or BCI, in December 2012 and Crosby Benefit Systems, Inc., or CBS, in May 2013. In addition, we completed one acquisition, in which we acquired TransitCenter, Inc., or TC, in February 2012. These portfolio purchases and this acquisition have enabled us to expand our employer client base, particularly in the SMB and public sector markets, and provided an opportunity to cross-sell additional CDB services to our newly acquired employer clients. The purchases of CB, PBS and BCI increased our COBRA service offerings, and the purchase of the FBM portfolio expanded our service capabilities to public sector clients. Our model for these portfolio purchases generally involves a payment at closing of the transaction and contingent payments based on achievement of revenue growth targets. There are several hundred regional TPA portfolios that we continually monitor and evaluate in order to maintain a robust pipeline of potential candidates for purchase and we intend to continue executing our focused strategy of portfolio purchases to broaden our employer client base. The acquisition of TC enabled us to further expand our commuter tax-advantaged benefit offerings in the SMB market with products tailored to SMB needs. We believe this acquisition will help solidify our position as a leading provider of commuter-related CDBs.

Portfolio purchases and acquisitions may have a short-term material adverse impact on our results of operations, including a potential material adverse impact on our cost of revenues, as we seek to migrate acquired employer clients to our proprietary technology platforms, typically over the succeeding 12 to 24 months, in order to achieve additional operating efficiencies. For example, our cost of revenues in the nine months ended September 30, 2013 included additional expenses of \$8.6 million due to the purchases of BCI and CBS. Additionally, from time to time, we may incur material costs and charges related to consolidating our operations following our portfolio purchases and acquisitions.

### *Ceridian Channel Partner Arrangement*

As part of our continuing efforts to grow our business through the acquisition of employer clients through various means, in July 2013, we entered into a channel partner arrangement with Ceridian, a global product and services company, pursuant to which Ceridian's Consumer-Directed Benefit account administration business will be substantially transitioned to us between October 2013 and January 2015. This new channel partner arrangement will not have a significant impact on revenue in 2013. In conjunction with the transition, we also entered into a separate reseller arrangement with Ceridian.

The final purchase price is calculated as a multiple of the expected annual revenue for each employer client successfully transitioned to us. The timing of the transition of revenue to us is dependent upon the employer clients executing new agreements with us and agreeing to a service conversion, a process whose timing and outcome is ultimately controlled by each employer client. The total purchase price is expected to be in the range of \$15.0 million to \$16.0 million and will be capitalized and amortized over the expected life of the client relationships once transitioned. In July 2013, we made an initial payment of \$15.0 million to Ceridian, in advance of any employer clients transitioning over to us. The \$15.0 million payment was recorded in the other assets line item in our consolidated balance sheet as of September 30, 2013. We will incur certain one-time transition costs, but the amount and timing of such costs remain uncertain until we and Ceridian have finalized the transition schedule.

*Aflac Channel Partner Arrangement*

In April 2012, the Company entered into a channel partner arrangement with American Family Life Assurance Company, or Aflac, pursuant to which Aflac's FSA and commuter account administration business would be transitioned to the Company. As of June 30, 2013, the transitioning of existing Aflac employer clients has been completed. We have made total payments to Aflac of \$7.2 million for all employer clients that transitioned to us. We have capitalized these payments as an intangible asset and are amortizing the asset over an expected life of 7 years.

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### *Follow-on Public Offerings*

On March 18, 2013, we closed a follow-on public offering and sold 500,000 shares of common stock at a price of \$24.00 per share, which raised \$11.6 million, net of underwriters' discounts and commissions. Certain selling stockholders, including VantagePoint, sold 5,131,115 shares of common stock in the offering. In addition, the underwriters exercised their overallotment option to purchase 844,667 additional shares from the selling stockholders. We did not receive any proceeds from the sale of shares by the selling stockholders.

On August 19, 2013, we closed a follow-on public offering pursuant to which certain selling stockholders, including VantagePoint, sold 2,968,276 shares of common stock. In addition, the underwriters exercised their overallotment option to purchase 445,241 additional shares from the selling stockholders. The shares were purchased at a price of \$39.54 per share, net of underwriters' discounts and commissions. We did not receive any proceeds from the sale of shares by the selling stockholders.

### *Consolidation of Operations*

We monitor our operating results and take steps to improve, redirect and consolidate our operations.

In the first quarter of 2013, we closed our Vista California facility and consolidated redundant activities within our operations, which resulted in the early termination of a lease and elimination of certain personnel. The expenses related to these actions were approximately \$0.4 million and were primarily driven by the termination of the lease.

In the second quarter of 2013, we decided not to renew our Leawood Kansas and Centennial Colorado office leases, which expired as of the end of the third quarter of 2013. We are not exiting the Leawood or Centennial markets, but have chosen not to maintain a physical presence at the two locations. We have incurred \$0.5 million and \$0.2 million in one-time severance and other benefit payments to various impacted employees related to the Leawood and Centennial office closures, respectively.

## **Key Components of Our Results of Operations**

### *Revenue*

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

#### *Healthcare Revenue*

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

revision. Revenue is recognized monthly as services are rendered under our written service agreements.

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

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*Commuter Revenue*

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

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

*Other Revenue*

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

***Costs and Expenses***

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

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

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

Cost of revenues also includes the losses or gains associated with processing our large volume of transactions, which we refer to as net processing losses or gains. In the normal course of our business, we make administrative and

processing errors that we cannot bill to our employer clients. For example, we may over-reimburse employee participants for claims they submit or incur the cost of replacing commuter passes that are not received by employee participants. Upon identifying such an error, we record the expense as a processing loss. In certain circumstances, we experience recoveries with respect to these amounts which are recorded as processing gains.

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

#### *Technology and Development*

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

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### *Sales and Marketing*

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

### *General and Administrative*

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

### *Amortization and Change in Contingent Consideration*

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

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

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

We measure acquired contingent consideration payable each reporting period at fair value and recognize changes in fair value in our consolidated statements of income each period, until the final amount payable is determined. Increases or decreases in the fair value of the contingent consideration payable can result from changes in revenue forecasts and risk and probability assumptions. Significant judgment is employed in determining the appropriateness of these assumptions in each period.

### *Other Income (Expense)*

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

### *Gain (Loss) on Revaluation of Warrants*

We account for freestanding warrants that are exercisable into shares of potentially redeemable preferred stock as liabilities by marking-to-market those warrants at each reporting period from the warrant issuance date until their exercise date or expiration. The changes resulting from marking-to-market are presented in our consolidated statements of income as gain (loss) on revaluation of warrants. Upon the automatic conversion of our preferred stock into common stock in connection with the closing of our IPO in May 2012, the warrants became exercisable for shares of common stock. As the warrant is no longer exercisable into share of redeemable preferred stock, we will no longer record any mark-to-market changes in the fair value of the warrant in the consolidated statements of income.

### *Provision for Income Taxes*

We are subject to taxation in the United States. Income taxes are computed using the asset and liability method, under which deferred tax assets and liabilities are determined based on the difference between the financial statement and tax bases of assets and liabilities using enacted tax rates in effect for the year in which the differences are expected to affect taxable income. As of September 30, 2013, we remain in a net deferred tax asset position. Valuation allowances are established when necessary to reduce net deferred tax assets to the amount expected to be realized.

At December 31, 2012, we had federal and state operating loss carryforwards of approximately \$38.2 million and \$36.9 million, respectively, available to offset future regular and alternative minimum taxable income. Our federal net operating loss carryforwards expire in the years 2023 through 2029, if not utilized. The state net operating loss carryforwards expire in the years 2017 through 2031. The federal and state amounts include tax deduction benefits related to stock options in the amount of \$2.7 million and \$1.2 million, respectively, that will be booked to additional paid-in capital and that will benefit the tax provision when utilized. We also have tax deductible goodwill related to asset acquisitions. In addition, we had federal and California research and development credit carryforwards of approximately \$2.6 million and \$1.4 million respectively, available to offset future tax liabilities. The federal research credit carryforwards expire beginning in the years 2022 through 2031, if not fully utilized. The California tax credit carryforward can be carried forward indefinitely.



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The American Taxpayer Relief Act of 2012, or the Act, was enacted on January 2, 2013. The Act reinstated the research and development credit retroactively to January 1, 2012 and extended it through 2013. The tax provision for the nine months ended September 30, 2013 includes a discrete item of \$0.3 million in 2012 research and development tax credits, net of reserves per the guidance in ASC 740, under this retroactive reinstatement by Congress in 2013.

Our ability to utilize the net operating losses and tax credit carryforwards are subject to restrictions, including limitations in the event of past or future ownership changes as defined in Section 382 of the Internal Revenue Code of 1986, as amended, and similar state tax law (including in connection with our March and August 2013 follow-on offerings). In general, an ownership change occurs if the aggregate stock ownership of certain stockholders increases by more than 50 percentage points over such stockholders' lowest percentage ownership during the testing period (generally three years). We completed Section 382 studies through December 31, 2011, and updated the analysis encompassing all common stock transactions through October 9, 2012, the date of our follow-on public offering, and have concluded that an ownership change occurred on October 9, 2012. The ownership change should not result in our net operating loss carryforwards or our research and development credits expiring unused. We completed follow-on offerings on March 18, 2013 and August 12, 2013, and evaluated those offerings along with other material ownership changes through September 30, 2013 and concluded that it would not result in any limitation in our use of our net operating loss carryforwards or our research and development credits.

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

### ***Accretion of Redemption Premium***

We accounted for redemption premium by recording accretion charges reflecting the changes in the redemption value of certain of our series of redeemable preferred stock over the period from the date of issuance to the earliest redemption date. Upon the completion of our IPO in May 2012, the redeemable preferred shares converted to common shares that are not redeemable. We performed the final re-measurement of the redeemable preferred stock at the effective date and the preferred stock was then reclassified from the mezzanine to equity. Subsequent to the effective date of our IPO, we have not recorded accretion of redeemable preferred shares.

### **Critical Accounting Policies and Significant Management Estimates**

There have been no material changes to our critical accounting policies and estimates during the nine months ended September 30, 2013, as compared to the critical accounting policies and estimates disclosed in Management's Discussion and Analysis of Financial Condition and Results of Operations included in our Annual Report on Form 10-K for the year ended December 31, 2012.

**Table of Contents****Results of Operations***Comparison of the Three and Nine Months Ended September 30, 2012 and 2013**Revenue*

	Three Months Ended September 30, 2013			Change from			Nine Months Ended September 30, 2013			Change from		
	2012	2013		2012	2013		2012	2013		2012	2013	
	(in thousands, unaudited)			prior year			(in thousands, unaudited)			prior year		
<b>Revenue:</b>												
Healthcare	\$ 26,508	\$ 32,646	23%	\$ 83,353	\$ 102,244	23%						
Commuter	13,090	14,949	14%	38,302	44,378	16%						
Other	2,940	5,976	103%	8,970	17,625	96%						
<b>Total revenue</b>	<b>\$ 42,538</b>	<b>\$ 53,571</b>	<b>26%</b>	<b>\$ 130,625</b>	<b>\$ 164,247</b>	<b>26%</b>						

*Healthcare Revenue*

The \$6.1 million increase in healthcare revenue for the third quarter of 2013 as compared to the third quarter of 2012 was primarily driven by a \$4.2 million increase in FSA revenue due to an increase in employee participation in our programs. The increase was primarily driven by \$1.7 million related to the Aflac channel partner arrangement, \$1.3 million in post-purchase revenues for BCI, which was acquired in December 2012, \$0.5 million in post-purchase revenues for CBS, which was acquired in May 2013 and \$0.3 million from the addition of a large employer client in the first quarter of 2013. Healthcare revenue was further increased by a \$1.4 million increase in HRA revenue primarily due to the addition of a large employer client.

The \$18.9 million increase in healthcare revenue for the first nine months of 2013 as compared to the first nine months of 2012 was primarily driven by a \$14.2 million increase in FSA revenue due to an increase in employee participation in our programs. The increase was primarily driven by \$5.5 million related to the Aflac channel partner arrangement, \$4.2 million in post-purchase revenues for BCI, \$0.9 million from the addition of a large employer client in the first quarter of 2013 and \$0.8 million in post-purchase revenues for CBS. The growth in healthcare revenue was further driven by a \$3.4 million increase in HRA revenue primarily due to the addition of a large employer client and \$0.7 million increase in HSA revenue due to growth in participation of our HSA programs.

*Commuter Revenue*

The \$1.9 million increase in commuter revenue for the third quarter of 2013 as compared to the third quarter of 2012 was driven by a \$0.5 million increase in TransitCheck Premium revenue and a \$0.3 million increase in Commuter Order Model revenue as the number of employee participants in these programs grew and as the statutory monthly cap was increased in the first quarter of 2013. Commuter revenue was further driven by a \$0.4 million increase in TransitCheck Basic revenue due to an increase in employee participants in the program and the increase in the statutory monthly cap increase. The remainder of the commuter revenue growth was primarily driven by \$0.3 million in increased interchange revenue as a result of increased debit card usage and \$0.2 million in transit agency commission revenue.

The \$6.1 million increase in commuter revenue for the first nine months of 2013 as compared to the first nine months of 2012 was primarily driven by a \$2.0 million increase in TransitCheck Premium revenue and a \$0.9 million increase in Commuter Order Model revenue as the number of employee participants in these programs grew and as the statutory monthly cap was increased in the first quarter of 2013. Commuter revenue was further driven by a \$1.8 million increase in TransitCheck Basic revenue due to an increase in employee participants in the program and the increase in the statutory monthly cap increase. The remainder of the commuter revenue growth was primarily driven by \$0.7 million in increased interchange revenue as a result of increased debit card usage and \$0.5 million in transit agency commission revenue.

**Table of Contents***Other Revenue*

The \$3.0 million increase in other revenue for the third quarter of 2013 as compared to the third quarter of 2012 was primarily driven by the inclusion of \$2.4 million in post-purchase COBRA revenues for BCI and \$0.6 million in post-purchase revenues for CBS.

The \$8.7 million increase in other revenue for the first nine months of 2013 as compared to the first nine months of 2012 was primarily driven by the inclusion of \$7.2 million in post-purchase COBRA revenues for BCI and \$1.0 million in post-purchase revenues for CBS. The remainder of other revenue growth was primarily driven by increased COBRA revenue due to increased participation by our existing employer clients.

*Cost of Revenues*

	Three Months Ended September 30, Change from			Nine Months Ended September 30, Change from		
	2012	2013	prior year	2012	2013	prior year
	(in thousands, unaudited)			(in thousands, unaudited)		
Cost of revenues (excluding amortization of internal use software)	\$ 15,210	\$ 19,300	27%	\$ 47,887	\$ 59,845	25%
Percent of revenue	36%	36%		37%	36%	

The \$4.1 million increase in cost of revenues for the third quarter of 2013 as compared to the third quarter of 2012 was primarily driven by increases in salaries and personnel-related costs of \$2.3 million, primarily as a result of post-purchase salaries and personnel-related costs from the BCI and CBS portfolio purchases, which increased headcount. The increase in cost of revenues was further driven by approximately \$1.7 million in outsourced services, printing and postage costs from the BCI and CBS portfolio purchases due to processing and supporting an increased number of employee participants and increases in stock-based compensation expense.

The \$12.0 million increase in cost of revenues for the first nine months of 2013 as compared to the first nine months of 2012 was primarily driven by increases in salaries and personnel-related costs of \$7.0 million, primarily as a result of post-purchase salaries and personnel-related costs from the BCI and CBS portfolio purchases, which increased headcount. Cost of revenues were further driven by the inclusion of approximately \$3.0 million in other post-purchase expenses for BCI and CBS, and \$1.8 million in outsource services costs resulting from processing and supporting an increased number of employee participants. Stock-based compensation expense increased \$0.5 million, primarily due to additional expense from new grants of restricted stock units and stock options, as well as adjustments related to performance based stock options. These increases were partially offset by lower net processing losses for the first nine months of 2013, compared to net processing losses for the first nine months of 2012, which had a \$0.5 million positive impact in 2013.

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



**Table of Contents****Technology and Development**

	Three Months Ended September 30, 2013			Change from prior year			Nine Months Ended September 30, 2013			Change from prior year		
	2012	2013		2012	2013		2012	2013		2012	2013	
	(in thousands, unaudited)			(in thousands, unaudited)			(in thousands, unaudited)			(in thousands, unaudited)		
Technology and development	\$ 4,784	\$ 4,934	3%	\$ 13,746	\$ 16,501	20%						
Percent of revenue	10%	9%		11%	10%							

The \$0.2 million increase in technology and development expenses for the third quarter of 2013 as compared to the third quarter of 2012 was primarily driven by post-purchase expenses for BCI and CBS of \$0.7 million, primarily as a result of increases in salaries and personnel-related costs due to an increase in headcount from the portfolio purchases. These increases were offset by reductions in salaries and personnel-related costs, temporary help and consulting services as a result of our continued company-wide efforts to consolidate operations.

The \$2.8 million increase in technology and development expenses for the first nine months of 2013 as compared to the first nine months of 2012 was driven by increases in salaries and personnel-related costs of \$2.4 million, primarily as a result of post-purchase salaries and personnel-related costs due to an increase in headcount from the BCI and CBS portfolio purchases and increased headcount to support improvements to our platform in handling the processing of claims. Technology and development expenses were further driven by the inclusion of approximately \$0.5 million in other post-purchase expenses for BCI and CBS and an increase in stock-based compensation expense of \$0.3 million from an increased number of stock option grants and restricted stock units being expensed, as well as adjustments related to performance based stock options and restricted stock units. These increases were partially offset by a \$0.7 million decrease in temporary help and consulting services due to consolidation of ongoing projects and contractors becoming full-time employees in 2013.

We intend to continue enhancing the functionality of our software platform as part of our continuous effort to improve our employer client and employee participant experience and to maintain and enhance our control and compliance environment. As a result of our focus on technology development and our CS and BCI portfolio purchases, we expect our technology and development expenses to increase in dollar amount in future periods. The timing of development and enhancement projects, including whether they are in phases where costs are capitalized or expensed, will significantly affect our technology and development expense both in dollar amount and as a percentage of revenue.

**Sales and Marketing**

	Three Months Ended September 30, 2013			Change from prior year			Nine Months Ended September 30, 2013			Change from prior year		
	2012	2013		2012	2013		2012	2013		2012	2013	
	(in thousands, unaudited)			(in thousands, unaudited)			(in thousands, unaudited)			(in thousands, unaudited)		
Sales and marketing	\$ 6,901	\$ 8,713	26%	\$ 21,377	\$ 25,637	20%						
Percent of revenue	16%	16%		16%	16%							

The \$1.8 million increase in sales and marketing expense for the third quarter of 2013 as compared to the third quarter of 2012 was primarily driven by salaries and personnel-related costs of \$0.8 million due to an increase in headcount from the BCI and CBS portfolio purchases, as well as increased hiring of sales and marketing personnel resulting from

the ongoing implementation of various new sales and marketing programs. Sales and marketing expenses were further driven by an increase in stock-based compensation

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expense of \$0.2 million from an increased number of stock option grants being expensed and travel and entertainment expense totaling \$0.2 million. Sales and marketing expenses were further driven by an increase in outsourcing services costs of \$0.3 million, related to the ongoing implementation of various new sales and marketing programs.

The \$4.3 million increase in sales and marketing expense for the first nine months of 2013 as compared to the first nine months of 2012 was primarily driven by salaries and personnel-related costs of \$2.6 million as a result of increased hiring of sales and marketing personnel resulting from the ongoing implementation of various new sales and marketing programs, increases in commission expense and an increase in headcount from the BCI and CBS portfolio purchases. Sales and marketing expenses were further driven by an increase in stock-based compensation expense of \$0.5 million from an increased number of stock option grants being expensed and travel and entertainment expense totaling \$0.3 million.

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

**General and Administrative**

	Three Months Ended September 30, 2013			Change from prior year			Nine Months Ended September 30, 2013			Change from prior year		
	2012	2013		2012	2013		2012	2013		2012	2013	
	(in thousands, unaudited)			(in thousands, unaudited)			(in thousands, unaudited)			(in thousands, unaudited)		
General and administrative	\$ 6,950	\$ 10,185	47%	\$ 21,753	\$ 28,402	31%						
Percent of revenue	16%	19%		17%	17%							

The \$3.2 million increase in general and administrative expenses for the third quarter of 2013 as compared to the third quarter of 2012 was primarily driven by an increase of \$1.1 million in stock-based compensation expense, primarily due to additional expense from new grants of restricted stock units and stock options as well as adjustments related to performance based stock options. General and administrative expenses were further driven by a \$0.9 million increase in professional fees, as a result of increased legal fees incurred as part of our follow-on public offering, required Securities and Exchange Commission filings and acquisitions. Professional fees were further driven by fees incurred as part of our efforts to enhance our control environment to meet compliance rules with Section 404 of the Sarbanes-Oxley Act. General and administrative expenses were further driven by salaries and personnel-related costs of \$0.6 million due to an increase in headcount as we continue to expand our operations and from the BCI and CBS portfolio purchases that added additional headcount. In the third quarter of 2012, a bad debt reserve totaling \$0.4 million was released, while no such release was made in the third quarter of 2013, resulting in increased expense for 2013.

The \$6.6 million increase in general and administration expenses for the first nine months of 2013 as compared to the first nine months of 2012 was primarily driven by an increase of \$2.3 million in stock-based compensation expense, primarily due to additional expense from new grants of restricted stock units and stock options as well as performance based restricted stock units. General and administrative expenses were further driven by salaries and personnel-related costs of \$1.6 million due to an increase in headcount as we continue to expand our operations and from the BCI and CBS portfolio purchases that added additional headcount. General and administrative expenses were further driven by a \$1.0 million increase in professional fees, as a result of increased legal fees incurred as part of our follow-on public offering, required Securities and Exchange Commission filings and acquisitions. Professional fees were further driven



by fees incurred as part of our efforts to enhance our control environment to meet compliance rules with Section 404 of the Sarbanes-Oxley Act. In fiscal 2012, a bad debt reserve totaling \$0.4 million was released, while no such release was made in the fiscal 2013, resulting in increased expense for 2013. General and administrative expenses also increased due to the inclusion of approximately \$0.3 million in other post-purchase expenses for BCI and CBS and \$0.4 million driven by increased allocation of facilities costs to general and administrative departments as a result of increased headcount, when compared to the same period a year ago.

General and administrative expenses as a percentage of revenue increased for the third quarter of 2013 as compared to the third quarter of 2012 by 3%. This increase was driven by significant increases in compensation expense related to our stock-based compensation arrangements.

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As we continue to grow, we expect our general and administrative expenses to continue to increase in dollar amount as we expand general and administrative headcount to support our continued growth and due to the increased expenses associated with being a public company.

**Amortization and Change in Contingent Consideration**

	Three Months Ended September 30, 2013			Change from prior year			Nine Months Ended September 30, 2013			Change from prior year		
	2012	2013		2012	2013		2012	2013		2012	2013	
	(in thousands, unaudited)			(in thousands, unaudited)			(in thousands, unaudited)			(in thousands, unaudited)		

Amortization and change in contingent consideration	\$ 3,713	\$ 554	-85%	\$ 12,245	\$ 9,741	-20%
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The decrease in the amortization and change in contingent consideration line item for the third quarter and for the first nine months of 2013 were driven by a gain of \$4.1 million related to the re-measurement of the contingent consideration related to BCI, as the timing of anticipated partnerships and employer clients were deferred until later in 2014 and into 2015, as such the anticipated revenue increase in 2014 and 2015 was adjusted in the forecasts. These decreases are partially offset by additional amortization of acquired intangible assets including the BCI portfolio purchase, the Aflac channel partnership arrangement and additional amortization of capitalized software development costs.

**Income Taxes**

	Three Months Ended September 30, 2013		Change from prior year		Nine Months Ended September 30, 2013		Change from prior year	
	2012	2013		2012	2013		2012	2013
	(in thousands, unaudited)			(in thousands, unaudited)			(in thousands, unaudited)	

Income taxes provision	\$ (2,034)	\$ (1,818)		\$ (5,007)	\$ (6,725)	
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Our provision for income taxes decreased from \$2.0 million for the third quarter of 2012 to \$1.8 million for the third quarter of 2013 due primarily to an increase in research and development tax credits. The tax provision for the three months ended September 30, 2013 includes a discrete item of \$0.1 million for employee stock purchase plan disqualifying dispositions.

Our provision for income taxes increased from \$5.0 million for the first nine months of 2012 to \$6.7 million for the first nine months of 2013, due primarily to the increase in income before taxes. The tax provision for the nine months ended September 30, 2013 includes discrete items of \$0.3 million primarily in 2012 Federal research and development tax credits, net of reserves per the guidance in ASC 740, that were retroactively reinstated by Congress in 2013 and \$0.2 million in employee stock purchase plan disqualifying dispositions.

The effective income tax rate for the three and nine months ended September 30, 2013 was impacted by an adjustment to the contingent consideration related to BCI, which is a non-taxable item.

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**Table of Contents****Liquidity and Capital Resources**

At September 30, 2013, our principal sources of liquidity were cash and cash equivalents totaling \$309.1 million comprised primarily of prefunds by clients of amounts to be paid on behalf of employee participants as well as, in recent years, other cash flows from operating activities. In connection with our follow-on public offering in March 2013, we received aggregate proceeds of \$11.6 million, net of underwriters' discounts and commissions but before deducting offering costs of \$0.8 million.

Prior to our public offerings, our operations had been financed primarily through cash flows from operating activities, the sale of convertible preferred stock and short and long-term borrowings.

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

***Prefunds***

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

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

By way of example, a new FSA enterprise employer client with a plan year starting January 1 will typically provide between 4-6% of the projected annual election for its employee participants as a prefund. In this example, we would

typically receive this prefunding in late December. Once the new plan year starts, the employee participants can immediately access all elected funds of their FSA benefit even before any payroll deductions have commenced. This access to funds differs from our HSA programs where available funds are added to employee participants' accounts only as payroll deductions occur and HRA programs where funds are only available as contributions are made.

Following the run-out period and grace period, the FSA prefunds from the prior plan year are reconciled and funds are returned to the employer clients, resulting in a substantial decline in our cash position. The cycle then repeats itself in each plan year as participants enroll in programs and prefunds are received in the fourth quarter for the new plan year. In a majority of cases, new FSA prefunds for the succeeding plan year are received prior to a plan year's prefund being fully paid out in the form of benefits for employee participants or being returned to the employer client. Because participant activity in our commuter programs varies monthly, prefunds for these programs fluctuate monthly.

Our enterprise client contracts do not contain restrictions on our use of enterprise client prefunds and, as a result, these prefunds are reflected as cash and cash equivalents on our balance sheet and changes in prefunds are recorded as an element of our cash flow 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.

**Table of Contents*****Union Bank Credit Facility***

Debt consists of borrowings under a Commercial Credit Agreement, or Revolver, with Union Bank, N.A., or UB, under which we can borrow an aggregate principal amount up to \$75.0 million. As collateral for the Revolver, the Company granted UB a security interest in all of the Company's assets. All of the Company's material existing and future subsidiaries are required to guaranty the Company's obligations under the Revolver. Such guarantees by existing and future material subsidiaries are and will be secured by substantially all of the property of such material subsidiaries.

Each loan under the credit facility bears interest at a fluctuating rate per annum equal to a base rate determined in accordance with the credit agreement, plus 0.25%, or, at our option, an interest rate equal to the LIBOR rate determined in accordance with the credit agreement, plus 2.50%. In the third quarter of 2013, we re-paid \$15.0 million and as of September 30, 2013, we had outstanding indebtedness under the Revolver of \$29.6 million. The interest rate applicable to the loan outstanding at September 30, 2013 is 2.9%. Principal, together with all accrued and unpaid interest, is due and payable on December 31, 2015.

The Revolver contains customary affirmative and negative covenants and also has financial covenants relating to a liquidity ratio, a ratio of indebtedness to EBITDA, a debt service coverage ratio and a minimum consolidated net worth covenant. We are obligated to pay customary commitment fees and letter of credit fees for a facility of this size and type.

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

***Cash Flows***

The following table presents information regarding our cash and cash equivalents as of December 31, 2012 and September 30, 2013:

	<b>December 31, 2012</b>	<b>September 30, 2013</b>
	<b>(in thousands) (unaudited)</b>	
Cash and cash equivalents, end of period	\$ 305,052	\$ 309,094

The following table presents information regarding our cash flows for the nine months ended September 30, 2012 and 2013:

	<b>Nine Months Ended September 30, 2012</b>	<b>2013</b>
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	<b>(in thousands)</b>	
	<b>(unaudited)</b>	
Net cash provided by operating activities	\$ 5,564	\$ 15,637
Net cash provided by (used in) investing activities	163	(24,513)
Net cash provided by financing activities	78,513	12,918
Net increase in cash and cash equivalents	\$ 84,240	\$ 4,042

**Table of Contents*****Cash Flows from Operating Activities***

**Nine Months Ended September 30,**  
**2012**                      **2013**  
**(in thousands)**  
**(unaudited)**

Net cash provided by operating activities	\$ 5,564	\$ 15,637
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Net cash provided by operating activities increased \$10.1 million during the year-to-date period ended September 30, 2013 compared to the year-to-date ended September 30, 2012, driven by an increase in net income of \$8.6 million for the first nine months of 2013 compared to the first nine months of 2012 and a decrease in cash outflow of \$7.8 million for customer obligations primarily due to the timing of our billing and increase in employer client payments of prefunds in 2013 when compared to 2012. Cash provided by operating activities were further impacted a by \$3.4 million payment of contingent consideration in excess of the initial measurement reflected in operating activities in the first nine months of 2012 while only a \$0.6 million payment related to contingent consideration in excess of the initial measurement was reflected in operating activities in the first nine months of 2013. These increases were partially offset by a \$7.1 million impact in excess tax benefit from the exercise of stock options and from an increase in accounts receivable in the first nine months of 2013 when compared to the first nine months of 2012, primarily from the timing and receipt of billing for funds owed by employer clients that had a \$3.8 million impact on operating cash.

***Cash Flows from Investing Activities***

**Nine Months Ended September 30,**  
**2012**                      **2013**  
**(in thousands)**  
**(unaudited)**

Net cash provided by (used in) investing activities	\$ 163	\$ (24,513)
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Net cash used in investing activities consists primarily of our investment in internal use software that is capitalized prior to it being available for its intended use, capital expenditures and purchases of portfolios.

Net cash used in investing activities increased \$24.7 million during the year-to-date period ended September 30, 2013 compared to the year-to-date period ended September 30, 2012, primarily due to a payment of \$15.0 million during the third quarter of 2013, in connection with advanced payment made to Ceridian for the employer clients that are expected to transition to WageWorks, while no such payments had been made during the first nine month of 2012. Cash used in investing activities was further increased by cash received in the acquisition of TransitChek during the first quarter of 2012, which had a positive cash inflow in investing activities of \$8.6 million for the first nine months of 2012, while the acquisition of Crosby Benefit Systems, Inc., during the second quarter of 2013 had a negative cash outflow of \$0.8 million for the first nine months of 2013 causing a negative year-over-year impact of \$9.4 million.

**Table of Contents****Cash Flows from Financing Activities**

**Nine Months Ended September 30,**  
**2012**                      **2013**  
**(in thousands)**  
**(unaudited)**

Net cash provided by financing activities	\$	78,513	\$	12,918
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Net cash provided by financing activities decreased \$65.6 million during the year-to-date period ended September 30, 2013 compared to the year-to-date period ended September 30, 2012, primarily due to cash received from our initial public offering and draw downs under the Revolver with UB during the first nine months of 2012 totaling \$92.1 million while we did not have these transactions during the first nine months of 2013. Cash provided by financing activities were further decreased by a \$15.0 million repayment of debt in the third quarter of 2013 under our Revolver with Union Bank. These decreases were partially offset by cash received from our follow-on offering that took place in the first quarter of 2013 of \$11.6 million and proceeds received from the exercise of stock options and issuance of stock under our employee stock purchase plan totaling \$15.9 million. The decreases in cash provided by financing activities were further offset by payments of contingent consideration made during the first nine months of 2012 totaling \$14.1 million while payments of contingent consideration made during the first nine months of 2012 only totaled \$6.6 million.

**Recently Issued Accounting Pronouncements**

See Note 1 of our accompanying consolidated financial statements for a full description of recent accounting pronouncements and our expectation of their impact, if any, on our results of operations and financial condition.

**Contractual Obligations**

The following table describes our contractual obligations as of September 30, 2013 (unaudited):

	<b>Total</b>	<b>Less than 1 year</b>	<b>1-3 years</b>	<b>3-5 years</b>	<b>More than 5 years</b>
Long-term debt obligations (1)	\$ 29,600	\$	\$ 29,600	\$	\$
Interest on long-term debt obligations (2)	1,931	858	1,073		
Operating lease obligations (3)	20,895	5,011	5,994	2,985	6,905
Acquisition payments (4)	12,020	5,210	6,810		
<b>Total</b>	<b>\$ 64,446</b>	<b>\$ 11,079</b>	<b>\$ 43,477</b>	<b>\$ 2,985</b>	<b>\$ 6,905</b>

(1) Credit facility: \$75.0 million credit facility with a variable interest rate of base rate plus 0.25% per annum or LIBOR plus 2.50% per annum, and a maturity date of December 31, 2015. At September 30, 2013, we had \$29.6 million of outstanding principal which is recorded net of debt issuance costs on our balance sheet. The debt issuance costs are not included in the table above.

(2)



Estimated interest payments assume the current weighted average interest rate of 2.9% per annum on a \$29.6 million principal amount through December 31, 2015.

- (3) We lease facilities under non-cancelable operating leases expiring at various dates through 2023.
- (4) Estimated undiscounted contingent consideration for companies acquired in 2012 and 2013. See Note 3 of our consolidated financial statements.

**Off-Balance Sheet Arrangements**

We have no off-balance sheet arrangements.

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### **Item 3. Quantitative and Qualitative Disclosures About Market Risk**

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

As of September 30, 2013, we had cash and cash equivalents of \$309.1 million. These amounts consist of cash on deposit with banks and money market funds. The cash and cash equivalents are held for working capital purposes. We do not enter into investments for trading or speculative purposes. Due to the short-term nature of these investments, we do not believe that changes in interest rates would have a material impact on our financial position and results of operations. However, declines in interest rates and cash balances will reduce future investment income.

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

Our exposure to market risk also relates to the increase or decrease in the amount of interest expense we must pay on our outstanding debt instruments. As of September 30, 2013, we had outstanding principal of \$29.6 million under our credit facility. Each loan under the credit facility bears interest at a fluctuating rate per annum equal to a base rate determined in accordance with the credit agreement, plus 0.25%, or, at our option, an interest rate equal to the LIBOR rate determined in accordance with the credit agreement, plus 2.50%. The increase in interest expense from the effect of a hypothetical change in interest rates of 1% would not have a material impact on our net income and cash flows.

### **Item 4. Controls and Procedures**

#### **Evaluation of Disclosure Controls and Procedures**

We maintain disclosure controls and procedures, as such term is defined in Rule 13a-15(e) under the Exchange Act, that are designed to ensure that information required to be disclosed by us in reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in rules and forms of the Securities and Exchange Commission, or the SEC, and that such information is accumulated and communicated to our management, including our chief executive officer and chief financial officer, as appropriate to allow timely decisions regarding required disclosure. In designing and evaluating our disclosure controls and procedures, management recognizes that disclosure controls and procedures, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the disclosure controls and procedures are met. Additionally, in designing disclosure controls and procedures, our management necessarily was required to apply its judgment in evaluating the cost-benefit relationship of possible disclosure controls and procedures. Based on their evaluation at the end of the period covered by this quarterly report on Form 10-Q, our chief executive officer and chief financial officer have concluded that our disclosure controls and procedures were effective at the reasonable assurance level.

#### **Changes in Internal Control over Financial Reporting**

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



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**PART II. OTHER INFORMATION**

**Item 1. Legal Proceedings**

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

**Item 1A. Risk Factors**

**RISK FACTORS**

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

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

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

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

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

Our recent growth has been, and our future growth will be, substantially dependent on our ability to continue to make and integrate acquisitions and complementary portfolio purchases to expand our employer client base and service

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

our ability to retain acquired employer clients and their associated revenues;

diversion of management's time and focus from operating our business to address integration challenges;

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our ability to retain or replace key employees from acquisitions and portfolios we acquire;

cultural and logistical challenges associated with integrating employees from acquired portfolios into our organization;

our ability to integrate the combined products, services and technology;

the migration of acquired employer clients to our technology platforms;

our ability to cross-sell additional CDB programs to acquired employer clients;

our ability to realize expected synergies;

the need to implement or improve internal controls, procedures and policies appropriate for a public company at businesses that, prior to the portfolio purchase or acquisition, may have lacked effective controls, procedures and policies, including, but not limited to, processes required for the effective and timely reporting of the financial condition and results of operations of the acquired business, both for historical periods prior to the acquisition and on a forward-looking basis following the acquisition;

possible write-offs or impairment charges that result from acquisitions and portfolio purchases;

unanticipated or unknown liabilities that relate to purchased businesses;

the need to integrate purchased businesses' accounting, management information, human resources, and other administrative systems to permit effective management; and

any change in one of the many complex federal or state laws or regulations that govern any aspect of the financial or business operations of our business and businesses we acquire, such as state escheatment laws.

Portfolio purchases and acquisitions may have a short-term material adverse impact on our results of operations, including a potential material adverse impact on our cost of revenues, as we seek to migrate acquired employer clients to our proprietary technology platforms, typically over the succeeding 12 to 24 months, in order to achieve additional operating efficiencies. For example, our cost of revenues in the nine months ended September 30, 2013 included additional expenses of \$8.6 million due to the purchase of BCI and CBS. Additionally, from time to time, we may incur material costs and charges related to consolidating our operations following our portfolio purchases and acquisitions.

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

Most of our revenue is derived from the long term, multi-year agreements that we typically enter into with our employer clients. The initial subscription period is typically three years for our larger employer clients, which we refer to as enterprise clients, and one to three years for our small- and medium-sized business, or SMB, clients. We also derive revenue from our channel partner agreements with American Family Life Assurance Company, or Aflac, and our new channel partner arrangement that we entered into in July 2013 with Ceridian. We may in the future establish new channel partnerships with other companies. Our employer clients, however, have no obligation to renew their agreements with us after the initial term and we cannot assure you that our employer clients will continue to renew their agreements at the same rate, if at all. In addition, employer clients transitioning to us from a channel partner have no obligation to enter agreements with us and, if they do, there is no guarantee that they will renew their agreements with us after the initial transition period.

Moreover, most of our employer clients have the right to cancel their agreements for convenience, subject to certain notice requirements. While few employer clients have terminated their agreements with us for convenience, some of our employer clients have elected not to renew their agreements with us. Our employer clients' renewal rates may decline or fluctuate as a result of a number of factors, including the prices of competing products or services or reductions in our employer clients' spending levels. Our ability to grow our business also depends upon our ability to maintain our existing channel partner relationships and develop new relationships. No assurance can be given that new channel partners will be found, that any such new relationships will be successful when they are in place, or that business with our current channel partners will increase. If our employer clients or channel partners do not renew their agreements with us, and we are unable to attract new employer clients or channel partners, our revenue may decline and our results of operations, financial condition, business and prospects may be materially adversely affected.

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

Our revenue model is substantially based on the number of employee participants enrolled in the CDB programs that we administer. We devote significant resources to educating both employers and their employees on the potential cost savings available to

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them from utilizing CDB programs. We have created various marketing, educational and awareness tools to inform employers about the benefits of offering CDB programs to their employees and how our services allow them to offer these benefits in an efficient and cost effective manner. We also provide marketing information to employees to inform them about the potential tax savings they can achieve by utilizing CDB programs to pay for their healthcare, commuter and other benefit needs. However, if more employers and employees do not both become aware of or understand these potential cost savings and choose to adopt CDB programs, our results of operations, financial condition, business and prospects may be materially adversely affected.

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

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

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

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

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

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



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

Changes in healthcare or other laws and regulations applicable to our business may occur that could increase our compliance and other costs of doing business, require significant systems enhancement, or render our products or services less profitable or obsolete, any of which could have a material adverse effect on our results of operations. For instance on March 13, 2013, the staff of the Federal Reserve Board of Governors issued an FAQ that called into question when PIN enabled prepaid debit cards needed to be made available. This caused our bank card issuers to request that we comply with this FAQ by April 1, 2013 and that we bear the cost associated with compliance. While we have been successful in explaining that the Durbin Amendment to the Electronic Fund Transfer Act regulates the issuers and therefore this is their cost to bear, they have tried and may continue to try to pass a portion of the implementation costs of such change to us. The Durbin Amendment to the Electronic Funds Transfer Act, establishes rules that implement interchange transaction fee restrictions and prohibitions against payment card network exclusivity arrangements and transaction routing restrictions related to the processing of electronic debit transactions. Although the rules do not include an explicit exemption for health benefit cards, our interchange fees are exempt from the Durbin Amendment because there is an exception for general purpose reloadable prepaid cards and some of such cards also fall outside the definitions that establish the scope of coverage

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While we do not currently expect that this will have, or is reasonably likely to have, a material adverse impact on our financial condition or operating results, we will need to continue to monitor the status of this rule as well as other potential changes in laws or regulations that may impact our business as such changes could potentially adversely affect our business, prospects and results of operations.

There has been an increasing political and regulatory focus on healthcare laws in recent years. While legislation such as the Patient Protection and Affordable Care Act has been signed into law, many of the details necessary to implement the legislation have yet to be defined. For example, any new laws that increase reporting and compliance burdens on employers may make them less likely to offer CDBs to their employees and instead offer employees benefit coverage through public exchanges. If employers are less incentivized to offer our CDB programs to employees because of increased regulatory burdens or otherwise, our results of operations and financial condition could be materially adversely affected.

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

We intend to continue to invest in technology and development to create new and enhanced products and services to offer our employer clients and their participating employees. During this past year, we have added several new features to our participant site and have continued to enhance the site's mobile compatibility. We also added more functionality to our EZ Receipts mobile application to enable participants to track and monitor their account information and activity on the go. To increase the value we deliver to our clients, we have also started updating the look and feel of our client facing website which includes the addition of a new graphic dashboard providing users access to key metrics. Scalability of our platform also remains an on-going focus as our platform volume increases. Investment in technology stack upgrades continue, to ensure stability and performance of our applications for our clients and participants. Our health and wellness offerings were also expanded over the past year to include online claims for our wellness product and the integration of a Wellness Portal to provide our users with the most up-to-date health and wellness information. We have limited experience in these areas and so we may not be able to anticipate or manage new risks and obligations or legal, compliance or other requirements that may arise. In addition, as the rules and regulations for participating in public exchanges are still being developed, it is unclear whether we will be able to sell all of our CDBs into these exchanges and what types of development we will need to invest in so that we can make our CDBs available in such exchanges. We may also need to develop new products and services in order to effectively compete within the public exchanges. The anticipated benefits of such new and improved products and services may not outweigh the costs and resources associated with their development.

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

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

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

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

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

***Our business and prospects may be materially adversely affected if we are unable to maintain high levels of service while reducing operating costs.***

One of the key attributes of our business is providing high quality service to our employer clients and their employee participants. While we have exceeded contractual service levels to our enterprise employer clients each month since May 2007, as our business grows and we service increasing numbers of employer clients and their employee participants, we may be unable to sustain these same levels of service, which could have a material adverse effect on our business. Alternatively, we may only be able to sustain high levels of service by significantly increasing our operating costs, which would materially adversely affect our operating results. If we are unable to maintain these high levels of service performance, our brand and reputation could suffer and our results of operations, financial condition, business and prospects would be materially adversely affected.

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

We will need to continue to expand our sales and marketing infrastructure in order to grow our employer client base and our business. We rely on our enterprise sales force to target new Fortune 1000 client accounts and sell into the private exchanges, as well as to cross-sell additional products and services to our existing enterprise clients. Effectively training our sales personnel requires significant time, expense and attention. In addition, we utilize various channel brokers, including insurance agents, benefits consultants, regional and national insurance carriers, health plans, payroll companies, banks and regional TPAs, to sell and market our programs to SMB employers. If we are unable to develop and expand our direct sales teams or these indirect sales channels, our ability to attract new employer clients, become a private exchange partner and cross-sell our programs may be negatively impacted and our growth opportunities will be reduced, each of which would materially adversely affect our results of operations, financial condition, business and prospects.

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

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

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

the need to educate potential employer clients about the uses and benefits of our CDB programs;

the relatively long duration of the commitment clients make in their agreements with us or with pre-existing plan administrators;

the discretionary nature of potential employer clients' purchasing and budget cycles and decisions;

the competitive nature of potential employer clients' evaluation and purchasing processes;

fluctuations in the CDB program needs of potential employer clients; and

lengthy purchasing approval processes of potential employer clients.

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

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

The number of accounts that generate revenue is typically greatest during our first calendar quarter due primarily to three factors. First, new employer clients and their employee participants typically begin service on January 1. Second, during the first calendar quarter, we are also servicing the end of plan year activity for existing clients, including assisting our clients with initiating the deduction of healthcare premiums on a tax deferred basis, and employee participants who do not continue participation into the next plan year. Third, we receive the majority of cash for pre-funded accounts from our employer clients in late December or early January, which results in higher cash balances during our first quarter.

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

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

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

Fluctuations in our quarterly operating results could cause our stock price to decline rapidly, may lead analysts to change their long-term models for valuing our common stock, could cause short-term liquidity issues, may impact our ability to retain or attract key personnel or cause other unanticipated issues. If our quarterly operating results or guidance fall below the expectations of research analysts or investors, the price of our common stock could decline substantially. Our quarterly operating expenses and operating results may vary significantly in the future and period-to-period comparisons of our operating results may not be meaningful. You should not rely on the results of one quarter as an indication of future performance.

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

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

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

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

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

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

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

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

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

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

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

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

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

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



as regulatory action, including financial penalties, which would materially adversely affect our brand, results of operations, financial condition, business and prospects.

***Privacy concerns could require us to modify our operations.***

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

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

As part of our efforts to continue the improvement of our enterprise resource planning, we plan to upgrade our existing information technology systems in order to automate several controls that are currently performed manually. We may experience

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difficulties in transitioning to these upgraded systems, including loss of data and decreases in productivity as personnel work to become familiar with these new systems. In addition, our management information systems will require modification and refinement as we grow and as our business needs change, which could prolong difficulties we experience with systems transitions, and we may not always employ the most effective systems for our purposes. If we experience difficulties in implementing new or upgraded information systems or experience significant system failures, or if we are unable to successfully modify our management information systems or respond to changes in our business needs, we may not be able to effectively manage our business and we may fail to meet our reporting obligations.

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

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

***We might require additional capital to support business growth in the future, and this capital might not be available on acceptable terms, if at all.***

We believe that our existing cash and cash equivalents, combined with our credit line and expected cash flow from operations, will be sufficient to meet our operating and capital requirements, as well as anticipated requirements for potential additional portfolio purchases, for at least the next 12 months. Our business and operations may, however, consume resources faster than we currently anticipate. We intend to continue to make investments to support our business growth, including through additional portfolio purchases of complementary businesses, and may require additional funds in the future to respond to business challenges, including the need to develop new features and platforms, enhance our existing programs or improve our operating infrastructure. Accordingly, we may seek to sell additional equity or debt securities or obtain additional debt financing. If we raise additional funds through further issuances of equity or convertible debt securities, our existing stockholders could suffer significant dilution, and any new equity securities we issue could have rights, preferences and privileges superior to those of holders of our common stock. Any debt financing secured by us in the future could involve restrictive covenants relating to our capital-raising activities and other financial and operational matters, which may make it more difficult for us to obtain additional capital and to pursue business opportunities, including potential portfolio purchases. We have not made arrangements to obtain additional financing and there can be no assurances that financing, if required, will be available in amounts or on terms acceptable to us, if at all.

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

We, and the banks that issue our prepaid debit cards, are subject to Visa and MasterCard association rules that could subject us to a variety of fines or penalties that may be levied by the card associations or networks for acts or

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

***Our results of operations, financial condition, business and prospects could be materially adversely affected if we experience unanticipated delays in rollouts by our employer clients of services to their employee participants.***

We generally do not earn fees from our employer clients until our services are available to their employee participants. If our infrastructure capacity is insufficient to meet our needs or if employer clients decide to delay implementation, we may experience delays in deploying our programs to new employer clients, or expanding the services we offer to existing employer clients, and on-boarding their employee participants. If the rollout of our services to our employer clients and, subsequently, their employee participants is delayed, our results of operations, financial condition, business and prospects could be materially adversely affected.

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

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

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

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

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

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

As of December 31, 2012, we had \$38.2 million of federal and \$36.9 million of state net operating loss carryforwards available to offset future taxable income. These net operating loss carryforwards will expire beginning in 2023 through 2029 for U.S. federal income tax purposes and beginning in 2017 through 2031 for state income tax purposes, if not fully utilized. In addition, we have federal and state research and development credit carryforwards of approximately \$2.6 million and \$1.4 million respectively. The federal research credit carryforwards expire beginning in 2022 through 2031, if not fully utilized. The California research credit carries forward indefinitely. Our ability to utilize net operating loss and tax credit carryforwards are subject to restrictions, including limitations in the event of past or future ownership changes as defined in Section 382 of the Internal Revenue Code of 1986, as amended, and similar state tax law (including in connection with our March and August 2013 follow-on offering). In general, an ownership change occurs if the aggregate stock ownership of certain stockholders increases by more than 50 percentage points over such stockholders' lowest percentage ownership during the testing period (generally three years). We completed Section 382 studies through December 31, 2011, and updated the analysis encompassing all common stock transactions through October 9, 2012, the date of our follow-on public offering, and have concluded that an ownership change occurred on October 9, 2012. The ownership change should not result in our net operating loss carryforwards or our research and development credits expiring unused. We completed follow-on offerings on March 18, 2013 and August 12, 2013, and evaluated those offerings along with other material ownership changes through September 30, 2013 and concluded that it would not result in any limitation in our use of our net operating loss carryforwards or our research and development credits.

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

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

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

Assertion of intellectual property infringement claims against us could result in litigation. We might not prevail in any such litigation or be able to obtain a license for the use of any infringed intellectual property from a third party on commercially reasonable terms, or at all. Even if obtained, we may be unable to protect such licenses from infringement or misuse, or prevent infringement claims against us in connection with our licensing efforts. Any such claims, regardless of their merit or ultimate outcome, could result

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in substantial cost to us, divert management's attention and our resources away from our operations and otherwise adversely affect our reputation. Our process for controlling our own employees' use of third-party proprietary information may not be sufficient to prevent assertions of intellectual property infringement claims against us.

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

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

***VantagePoint Capital Partners holds a high percentage of our common stock, which may limit the ability of our public stockholders to affect significant corporate actions.***

As of September 30, 2013, funds affiliated with VantagePoint Capital Partners, or VantagePoint, held approximately 11% of our outstanding common stock. In addition, we and VantagePoint are parties to a stockholder agreement related to a number of board of directors, stockholder and related governance matters. The stockholder agreement provides that VantagePoint has the right to designate (and remove or replace) two members of our board of directors if VantagePoint owns between 20% and 50% of our outstanding shares and one member of our board of directors if VantagePoint owns between 10% and 20% of our outstanding shares. VantagePoint also has the right to select one of its board designees to serve on our compensation committee, our nominating and corporate governance committee and any other special committee of our board of directors and has access to our books and records, so long as it continues to hold at least 10% of our outstanding shares. Additionally, so long as VantagePoint holds any of our shares, we may not amend any provision of our certificate of incorporation or bylaws relating to VantagePoint's rights without VantagePoint's consent. VantagePoint is not prohibited from selling its interest in us to a third party.

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

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

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

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

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

We have, in the past, experienced issues with our internal control over financial reporting. For example, three significant deficiencies were identified in internal controls in connection with the preparation of our financial statements and the audit of our financial results for 2010. We had significant deficiencies relating to: the completion of our financial reporting cycle within the expected period and our ability to produce reliable financial statements in the period that would normally be expected of a public

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company; our ability to timely integrate accounting functions of certain of our portfolio purchases; and certain inconsistencies and omissions in some of our key documents and agreements. The lack of timely financial reporting involved adjustments of a bonus accrual that was not timely made and the number of errors, missing disclosures and incorrect numbers in the financial statements we delivered to our independent registered public accounts for audit. The inability to timely integrate the accounting function of portfolio purchases related to our inability through March 2011 to reconcile an opening balance sheet for our PBS acquisition on August 31, 2010. The inconsistencies and omissions in key documents related to certain agreements that were not appropriately documented or referred to other agreements that did not exist, including agreements relating to our acquisition of the CDB assets of FBM.

In connection with the preparation of our financial statements and the audit of our financial results for 2011, it was determined that we remediated the significant deficiency relating to lack of timely financial reporting and reliable financial statements by the hiring of additional qualified accounting personnel. It was also determined that we remediated the significant deficiency related to inconsistencies and omissions in some of our key documents and agreements.

Since we did not complete any portfolio purchases in 2011, we were unable to remediate the significant deficiency with respect to timely integration of the accounting function of portfolio purchases in 2011; however, in connection with the preparation of our financial statements and the audit of our financial results for 2012, it was determined that we remediated this significant deficiency by assessing earlier the accounting function at the company from which the portfolio is purchased and allocation of needed resources, including the hiring of consultants, to assure timely integration. For example, for the acquisition and portfolio purchases that we have completed in 2012, we have assigned a full-time accounting resource and a consultant to lead the accounting integration of CS, TC and BCI.

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

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

Sales of substantial amounts of our common stock in the public market, or the perception that these sales could occur, could adversely affect the market price of our common stock and impair our ability to raise capital through offerings of our common stock. As of September 30, 2013, we had 34,557,335 shares of our common stock outstanding. In addition, as of September 30, 2013, there were outstanding options to purchase 3,167,829 shares of our common stock. Substantially all of our outstanding common stock is eligible for sale, subject to Rule 144 volume limitations for holders affected by such limitations, as are common stock issuable under vested and exercisable options. If our existing stockholders sell a large number of common stock or the public market perceives that existing stockholders might sell our common stock, the market price of our common stock could decline significantly. These sales might also make it more difficult for us to sell equity securities at a time and price that we deem appropriate.

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

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



actual or anticipated fluctuations in our financial results;

the financial projections we provide to the public, any changes in these projections or our failure to meet these projections;

failure of securities analysts to initiate or maintain coverage of our company, changes in financial estimates by any securities analysts who follow our company, or our failure to meet these estimates or the expectations of investors;

ratings changes by any securities analysts who follow our company;

announcements by us or our competitors of significant technical innovations, acquisitions, strategic partnerships, joint ventures or capital commitments;

changes in operating performance and stock market valuations of other newly public companies generally, or those in our industry in particular;

changes brought about by health care reform and the emergence of federal, state and private exchanges;

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price and volume fluctuations in the overall stock market, including as a result of trends in the global economy;

any major change in our board of directors or management;

lawsuits threatened or filed against us; and

other events or factors, including those resulting from war, incidents of terrorism or responses to these events.

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

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

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

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

authorize blank check preferred stock, which could be issued by the board of directors without stockholder approval and may contain voting, liquidation, dividend and other rights superior to our common stock;

limit the ability of our stockholders to call and bring business before special meetings;

require advance notice of stockholder proposals for business to be conducted at meetings of our stockholders and for nominations of candidates for election to our board of directors;

control the procedures for the conduct and scheduling of board of directors and stockholder meetings; and

provide the board of directors with the express power to postpone previously scheduled annual meetings and to cancel previously scheduled special meetings.

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

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

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

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

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

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

**Unregistered Sales of Equity Securities**

None.

**Use of Proceeds from Public Offerings of Common Stock**

On May 15, 2012, we closed our initial public offering and sold 7,475,000 shares of common stock (inclusive of 975,000 shares of common stock from the full exercise of the overallotment option of shares granted to the underwriters). All of the shares offered and sold in the initial public offering were registered under the Securities Act pursuant to a registration statement on Form S-1 (File No. 333-173709), which the SEC declared effective on May 9, 2012. William Blair & Company, L.L.C.; Stifel, Nicolaus & Company, Incorporated; JMP Securities LLC and Needham & Company, LLC acted as the underwriters. The public offering price of the shares sold in the offering was \$9.00 per share. The total gross proceeds from the offering to us were \$67.3 million. After deducting underwriting discounts and commissions of \$4.7 million and offering expenses payable by us of \$5.5 million, we received approximately \$57.0 million. No payments were made by us to directors, officers or persons owning ten percent or more of our common stock or to their associates, or to our affiliates, other than payments in the ordinary course of business to officers for salaries. There has been no material change in the planned use of proceeds from our initial public offering as described in our final prospectus filed with the SEC on May 10, 2012 pursuant to Rule 424(b) of the Securities Act. We invested the funds received in registered money market funds.

**Item 6. Exhibits**

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

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**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: November 5, 2013

By: /s/ Richard T. Green  
Richard T. Green  
Chief Financial Officer  
(Principal Financial and Accounting Officer)

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<b>Exhibit</b>		<b>Incorporated by Reference</b>						
		<b>No.</b>	<b>Exhibit Description</b>	<b>Form</b>	<b>File No.</b>	<b>Exhibit</b>	<b>Filing Date</b>	<b>Filed Herewith</b>
31.1			Certification of the Principal Executive Officer Pursuant to Exchange Act Rules 13a-14(a) and 15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002					X
31.2			Certification of the Principal Financial Officer Pursuant to Exchange Act Rules 13a-14(a) and 15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002					X
32.1(1)			Certification of the Principal Executive Officer and Principal Financial Officer Pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002					X
101.INS			XBRL Instance Document					X
101.SCH			XBRL Taxonomy Schema Linkbase Document					X
101.CAL			XBRL Taxonomy Calculation Linkbase Document					X
101.DEF			XBRL Taxonomy Definition Linkbase Document					X
101.LAB			XBRL Taxonomy Labels Linkbase Document					X
101.PRE			XBRL Taxonomy Presentation Linkbase Document					X

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