Paylocity Holding Corp
Form 10-Q
February 07, 2019
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, DC 20549

Form 10-Q

Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For the quarterly period ended December 31, 2018

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 001-36348

PAYLOCITY HOLDING CORPORATION

(Exact name of registrant as specified in its charter)

Delaware	46-4066644
(State or other jurisdiction of incorporation or organization)	(IRS Employer Identification No.)

1400 American Lane

Schaumburg, Illinois	60173
(Address of principal executive offices)	(Zip Code)

(847) 463-3200

(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 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 every Interactive Data File required to be submitted 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 such files). Yes No

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

Large Accelerated Filer	Accelerated Filer
Non-Accelerated Filer	Smaller Reporting Company
	Emerging Growth Company

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

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date: 52,915,940 shares of Common Stock, $0.001 par value per share, as of January 31, 2019.

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Paylocity Holding Corporation

Form 10-Q

For the Quarterly Period Ended December 31, 2018

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PART I

FINANCIAL INFORMATION

Item 1. Financial Statements

PAYLOCITY HOLDING CORPORATION

Unaudited Consolidated Balance Sheets

(in thousands, except per share data)

	June 30, 2018	December 31, 2018
Assets		
Current assets:		
Cash and cash equivalents	$ 137,193	$ 84,114
Corporate investments	732	19,934
Accounts receivable, net	3,453	4,267
Deferred contract costs	—	17,665
Prepaid expenses and other	11,248	12,553
Total current assets before funds held for clients	152,626	138,533
Funds held for clients	1,225,614	1,258,773
Total current assets	1,378,240	1,397,306
Capitalized internal-use software, net	21,094	23,163
Property and equipment, net	62,029	62,662
Intangible assets, net	13,002	11,876
Goodwill	9,590	9,590
Long-term deferred contract costs	—	64,598
Long-term prepaid expenses and other	1,504	3,266
Deferred income tax assets, net	22,140	7,891
Total assets	$ 1,507,599	$ 1,580,352
Liabilities and Stockholders' Equity		
Current liabilities:		
Accounts payable	$ 2,990	$ 3,498
Accrued expenses	42,241	43,207
Total current liabilities before client fund obligations	45,231	46,705
Client fund obligations	1,225,614	1,258,773

Total current liabilities	1,270,845	1,305,478
Deferred rent	22,812	22,342
Other long-term liabilities	1,118	1,595
Total liabilities	$ 1,294,775	$ 1,329,415
Stockholders’ equity:		
Preferred stock, $0.001 par value, 5,000 authorized, no shares issued and outstanding at June 30, 2018 and December 31, 2018	$ —	$ —
Common stock, $0.001 par value, 155,000 shares authorized at June 30, 2018 and December 31, 2018; 52,758 shares issued and outstanding at June 30, 2018 and 52,887 shares issued and outstanding at December 31, 2018	53	53
Additional paid-in capital	219,588	189,473
Retained earnings (accumulated deficit)	(6,678)	61,550
Accumulated other comprehensive loss	(139)	(139)
Total stockholders’ equity	$ 212,824	$ 250,937
Total liabilities and stockholders’ equity	$ 1,507,599	$ 1,580,352

See accompanying notes to unaudited consolidated financial statements.

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PAYLOCITY HOLDING CORPORATION

Unaudited Consolidated Statements of Operations and Comprehensive Income

(in thousands, except per share data)

	Three Months Ended December 31,		Six Months Ended December 31,	
	2017	2018	2017	2018
Revenues:				
Recurring fees	$ 81,292	$ 100,275	$ 158,586	$ 196,036
Interest income on funds held for clients	1,783	4,465	3,400	7,967
Total recurring revenues	83,075	104,740	161,986	204,003
Implementation services and other	2,929	2,464	5,518	3,705
Total revenues	86,004	107,204	167,504	207,708
Cost of revenues:				
Recurring revenues	25,638	31,206	49,729	60,437
Implementation services and other	11,202	6,864	22,070	13,575
Total cost of revenues	36,840	38,070	71,799	74,012
Gross profit	49,164	69,134	95,705	133,696
Operating expenses:				
Sales and marketing	21,598	26,570	42,778	52,988
Research and development	9,274	12,798	18,169	24,198
General and administrative	18,159	22,739	34,110	45,707
Total operating expenses	49,031	62,107	95,057	122,893
Operating income	133	7,027	648	10,803
Other income	141	346	250	615
Income before income taxes	274	7,373	898	11,418
Income tax expense (benefit)	(157)	1,669	(76)	(4,138)
Net income	$ 431	$ 5,704	$ 974	$ 15,556
Other comprehensive loss, net of tax				
Unrealized losses on securities, net of tax	(105)	(15)	(110)	—
Total other comprehensive loss, net of tax	(105)	(15)	(110)	—
Comprehensive income	$ 326	$ 5,689	$ 864	$ 15,556

Net income per share:

Basic	$ 0.01	$ 0.11	$ 0.02	$ 0.29
Diluted	$ 0.01	$ 0.10	$ 0.02	$ 0.28
Weighted-average shares used in computing net income per share:				
Basic	52,502	52,842	52,197	52,853
Diluted	54,818	55,081	54,639	55,232

See accompanying notes to unaudited consolidated financial statements.

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PAYLOCITY HOLDING CORPORATION

Unaudited Consolidated Statement of Changes in Stockholders' Equity

(in thousands)

	Stockholders' Equity					
	Common Stock		Additional Paid-in	Retained Earnings (Accumulated	Accumulated Other Comprehensive	Total Stockholders'
	Shares	Amount	Capital	Deficit)	Loss	Equity
Balances at June 30, 2018	52,758	$ 53	$ 219,588	$ (6,678)	$ (139)	$ 212,824
Cumulative effect of change in accounting policy (adoption of Topic 606)	—	—	—	52,672	—	52,672
Stock-based compensation	—	—	20,845	—	—	20,845
Stock options exercised	212	—	2,657	—	—	2,657
Issuance of common stock upon vesting of restricted stock units	604	—	—	—	—	—
Issuance of common stock under employee stock purchase plan	58	—	2,824	—	—	2,824
Net settlement for taxes and/or exercise price related to equity awards	(303)	—	(21,450)	—	—	(21,450)
Repurchases of common shares	(442)	—	(34,991)	—	—	(34,991)
Net income	—	—	—	15,556	—	15,556
Balances at December 31, 2018	52,887	$ 53	$ 189,473	$ 61,550	$ (139)	$ 250,937

See accompanying notes to the unaudited consolidated financial statements.

PAYLOCITY HOLDING CORPORATION

Unaudited Consolidated Statements of Cash Flows

(in thousands)

	Six Months Ended December 31, 2017	2018
Cash flows from operating activities:		
Net income	$ 974	$ 15,556
Adjustments to reconcile net income to net cash provided by operating activities:		
Stock-based compensation expense	14,424	19,524
Depreciation and amortization expense	13,438	16,801
Deferred income tax benefit	(93)	(4,139)
Provision for doubtful accounts	76	112
Net accretion of discounts and amortization of premiums on available-for-sale securities	(141)	(893)
Net realized losses on sales of available-for-sale securities	2	—
Loss on disposal of equipment	106	357
Changes in operating assets and liabilities:		
Accounts receivable	(775)	(926)
Deferred contract costs	—	(14,156)
Prepaid expenses and other	1,583	635
Accounts payable	(88)	147
Accrued expenses	(1,290)	1,027
Tenant improvement allowance	5,952	251
Net cash provided by operating activities	34,168	34,296
Cash flows from investing activities:		
Purchases of available-for-sale securities	(95,207)	(117,054)
Proceeds from sales and maturities of available-for-sale securities	23,181	88,879
Net change in funds held for clients' cash and cash equivalents	(331,078)	(24,191)
Capitalized internal-use software costs	(7,146)	(9,425)
Purchases of property and equipment	(7,998)	(7,532)
Lease allowances used for tenant improvements	(5,952)	(251)
Net cash used in investing activities	(424,200)	(69,574)
Cash flows from financing activities:		
Net change in client fund obligations	403,243	33,159
Repurchases of common shares	—	(34,991)
Proceeds from exercise of stock options	—	85

Proceeds from employee stock purchase plan	2,045	2,824
Taxes paid related to net share settlement of equity awards	(7,697)	(18,878)
Net cash provided by (used in) financing activities	397,591	(17,801)
Net Change in Cash and Cash Equivalents	7,559	(53,079)
Cash and Cash Equivalents—Beginning of Period	103,468	137,193
Cash and Cash Equivalents—End of Period	$ 111,027	$ 84,114
Supplemental Disclosure of Non-Cash Investing and Financing Activities		
Purchase of property and equipment and internal-use software, accrued but not paid	$ 482	$ 252
Supplemental Disclosure of Cash Flow Information		
Cash paid for income taxes, net of refunds	$ 60	$ 357

See accompanying notes to unaudited consolidated financial statements.

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PAYLOCITY HOLDING CORPORATION

Notes to the Unaudited Consolidated Financial Statements

(all amounts in thousands, except per share data)

(1) Organization and Description of Business

Paylocity Holding Corporation (the "Company") is a cloud-based provider of payroll and human capital management software solutions for medium-sized organizations. Services are provided in a Software-as-a-Service ("SaaS") delivery model utilizing the Company's cloud-based platform. Payroll services include collection, remittance and reporting of payroll liabilities to the appropriate federal, state and local authorities.

(2) Summary of Significant Accounting Policies

(a) Consolidation and Use of Estimates

These unaudited consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles ("GAAP"). The unaudited consolidated financial statements include the accounts of the Company and its wholly owned subsidiaries. All intercompany accounts and transactions have been eliminated in consolidation.

The preparation of consolidated financial statements in conformity with 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 consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Future events and their effects cannot be predicted with certainty; accordingly, accounting estimates require the exercise of judgment. Accounting estimates used in the preparation of these consolidated financial statements change as new events occur, as more experience is acquired, as additional information is obtained and as the operating environment changes.

The Company began investing corporate funds in available-for-sale securities during the first quarter of fiscal 2019 and as a result, reclassified $732 as of June 30, 2018 from prepaid expenses and other on the unaudited consolidated balance sheets to corporate investments for comparability purposes in order to conform to the current year's presentation.

(b) Interim Unaudited Consolidated Financial Information

The accompanying unaudited consolidated financial statements and notes have been prepared in accordance with GAAP and applicable rules and regulations of the Securities and Exchange Commission ("SEC") regarding interim financial reporting. Accordingly, they do not include all of the information and notes required by GAAP for complete financial statements. In the opinion of management, the interim financial information includes all adjustments of a normal recurring nature necessary for a fair presentation of the Company's financial position, results of operations, changes in stockholders' equity and cash flows. The results of operations for the three and six months ended December 31, 2018 are not necessarily indicative of the results for the full year or the results for any future periods. These unaudited consolidated financial statements should be read in conjunction with the audited consolidated financial statements and related notes for the year ended June 30, 2018 included in the Company's Annual Report on Form 10-K filed with the SEC on August 10, 2018.

(c) Revenue Recognition

The Company adopted Accounting Standards Update ("ASU") 2014-09, Revenue from Contracts with Customers ("Topic 606") effective as of July 1, 2018. Topic 606 requires revenue to be recognized when an entity transfers control of goods or services to a customer in an amount that reflects the consideration to which a company expects to be entitled to for those goods or services. To achieve this core principle, the Company recognizes revenue from contracts with customers based on the following five steps:

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1) Identify the contract with a customer;
2) Identify the performance obligations in the contract;
3) Determine the transaction price;
4) Allocate the transaction price to performance obligations in the contract; and
5) Recognize revenue when or as the Company satisfies a performance obligation.

The Company derives its revenue from contracts predominantly from recurring and non-recurring service fees. While the majority of its agreements are generally cancellable by the client on 60 days' notice or less, the Company began entering into term arrangements in fiscal 2018, which are generally two years long. Recurring fees are derived from payroll, timekeeping, and HR-related cloud-based computing services as follows:

· Payroll processing and related services, including payroll reporting and tax filing services are delivered on a weekly, biweekly, semi-monthly, or monthly basis depending upon the payroll frequency of the client and on an annual basis if a client selects W-2 preparation and processing services,

· Time and attendance reporting services, including time clock rentals, are delivered on a monthly basis, and

· Cloud-based HR software solutions, including employee administration and benefits enrollment and administration, are delivered on a monthly basis.

The majority of the Company's recurring fees are satisfied over time as services are provided. The performance obligations related to payroll services are satisfied upon the processing of the client's payroll with the fee charged and collected based on a per employee per payroll frequency fee. The performance obligations related to time and attendance services and HR related services are satisfied over time each month with the fee charged and collected based on a per employee per month fee. For subscription based fees which can include payroll, time and attendance and HR related services, the Company recognizes the applicable recurring fees over time each month with the fee charged and collected based on a per employee per month fee. The Company has certain optional performance obligations that are satisfied at a point in time including the sales of time clocks and W-2 services.

Non-recurring service fees consist mainly of nonrefundable implementation fees, which involve setting the client up in, and loading data into, the Company's cloud-based applications. These implementation activities are considered set-up activities. The Company has determined that the nonrefundable upfront fees provide certain clients with a material right to renew the contract. Implementation fees are deferred and amortized generally over a period up to 24 months.

Sales taxes collected from clients and remitted to governmental authorities where applicable are accounted for on a net basis and therefore are excluded from revenues in the statements of operations and comprehensive income.

Interest income collected on funds held for clients is recognized in recurring revenues when earned as the collection, holding and remittance of these funds are components of providing these services.

The following table, consistent with the presentation of its unaudited consolidated statements of operations and comprehensive income, disaggregates revenue by recurring fees and implementation services and other, which it believes represents the major categories of revenue:

	Three Months Ended December 31, 2018	Six Months Ended December 31, 2018
Recurring fees	$ 100,275	$ 196,036
Implementation services and other	2,464	3,705
Total revenues from contracts	$ 102,739	$ 199,741

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Deferred revenue

The timing of revenue recognition for recurring revenue is consistent with the timing of invoicing as they occur simultaneously upon the client payroll-processing period or by month. As such, the Company does not recognize contract assets or liabilities related to recurring revenue.

The nonrefundable upfront fees related to implementation services are invoiced with the client's first payroll period. The Company defers these nonrefundable upfront fees generally over a period up to 24 months based on the type of contract. The following table summarizes the changes in deferred revenue (i.e. contract liability) related to these nonrefundable upfront fees as follows:

	Three Months Ended December 31, 2018	Six Months Ended December 31, 2018
Balance at beginning of period	$ 2,019	$ —
Deferral of revenue	2,995	5,513
Revenue recognized	(1,391)	(1,890)
Balance at end of period	$ 3,623	$ 3,623

Deferred revenue related to these nonrefundable upfront fees are recorded within accrued expenses and other long-term liabilities on the unaudited consolidated balance sheets. The Company expects to recognize these deferred revenue balances of $2,089 in fiscal 2019, $1,162 in fiscal 2020, and $372 thereafter.

Deferred contract costs

The Company defers certain selling and commission costs that meet the capitalization criteria under ASC 340-40, which were expensed as incurred prior to the adoption of Topic 606. The Company also capitalizes certain costs to fulfill a contract related to its proprietary products if they are identifiable, generate or enhance resources used to satisfy future performance obligations and are expected to be recovered under ASC 340-40. As discussed in Note 2(e), the Company determined that implementation services related to its proprietary products are not separate performance obligations for contracts entered into after July 1, 2018. Implementation fees are treated as nonrefundable upfront fees and the related implementation costs are required to be capitalized and amortized over the expected period of benefit, which is the period in which the Company expects to recover the costs and enhance its ability to satisfy future performance obligations.

The Company utilizes the portfolio approach to account for both the cost of obtaining a contract and the cost of fulfilling a contract. These capitalized costs are amortized over the expected period of benefit, which has been determined to be over 7 years based on the Company's average client life and other qualitative factors, including rate of technological changes. The Company does not incur any additional costs to obtain or fulfill contracts upon renewal. The Company recognizes additional selling and commission costs and fulfillment costs when an existing client purchases additional services. These additional costs only relate to the additional services purchased and do not relate to the renewal of previous services.

The following tables present the deferred contract costs balances and the related amortization expense for these deferred contract costs:

	For the three months ended December 31, 2018			
	Beginning Balance	Capitalized Costs	Amortization	Ending Balance
Costs to obtain a new contract	$ 69,933	$ 5,635	$ (4,092)	$ 71,476
Costs to fulfill a contract	5,343	5,776	(332)	10,787
Total	$ 75,276	$ 11,411	$ (4,424)	$ 82,263

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	For the six months ended December 31, 2018			
	Beginning Balance	Capitalized Costs	Amortization	Ending Balance
Costs to obtain a new contract	$ 68,107	$ 11,346	$ (7,977)	$ 71,476
Costs to fulfill a contract	—	11,250	(463)	10,787
Total	$ 68,107	$ 22,596	$ (8,440)	$ 82,263

Deferred contract costs are recorded within deferred contract costs and long-term deferred contract costs on the unaudited consolidated balance sheets. Amortization of deferred contract costs is recorded in implementation services and other cost of revenue, sales and marketing, and general and administrative in the unaudited consolidated statements of operations and comprehensive income.

Remaining Performance Obligations

The Company has applied the practical expedients as allowed under Topic 606 and elects not to disclose the value of unsatisfied performance obligations for contracts that have an original expected duration of one year or less and contracts for which the variable consideration is allocated entirely to wholly unsatisfied performance obligations. The Company’s remaining performance obligations related to minimum monthly fees on its term based contracts was approximately $31,760 as of December 31, 2018, which will be generally recognized over the next 24 months.

(d) Income Taxes

Income taxes are accounted for in accordance with ASC 740, Income Taxes, using the asset and liability method. The Company’s provision for income taxes is based on the annual effective rate method. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases and tax credit carryforwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date.

The Company recognizes deferred tax assets to the extent that it believes that these assets are more likely than not to be realized. In making such a determination, the Company considers all available positive and negative evidence, including future reversals of existing taxable temporary differences, projected future taxable income, tax-planning strategies, and results of recent operations. If the Company determines that it would be able to realize its deferred tax assets in the future in excess of their net-recorded amount, it would make an adjustment to the deferred tax asset valuation allowance, which would reduce the provision for income taxes.

(e) Recently Adopted Accounting Standards

In May 2014, the FASB issued ASU 2014-09, Revenue from Contracts with Customers (Topic 606). Topic 606 supersedes a majority of existing revenue recognition guidance under GAAP, and requires companies to recognize revenue when it transfers goods or services to a customer in an amount that reflects the consideration to which a company expects to be entitled. The standard also provides guidance on the recognition of costs related to obtaining and fulfilling a contract under Subtopic 340-40, Other Assets and Deferred Costs – Contracts with Customers. The Company adopted the new standard, including subsequent amendments and Subtopic 340-40, effective as of July 1, 2018 using the modified retrospective method of transition, which limited the application of the new standard only to contracts that were not completed as of the effective date. The adoption of Topic 606 did not have a material impact in the timing or amount of revenue recognized. However, it did have a material impact on its unaudited consolidated balance sheet due to the deferral of costs of obtaining and fulfilling a contract as detailed below. The Company has updated its control framework for new internal controls and has updated existing controls relating to the new standard.

Under the legacy revenue standard through fiscal 2018, the Company accounted for implementation and recurring services each as a separate unit of account. The Company was able to establish standalone value for implementation services as supported by the activity of third-party resellers and other vendors that performed certain implementation services. The Company has observed that third party implementation activity has continued to decrease over time and at the same time, the Company has invested in proprietary applications and processes that impact

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implementation activities. The Company determined that from July 1, 2018 forward it no longer had a sufficient basis to establish standalone value of implementations for its proprietary products due to the culmination of the changes to the Company’s applications and processes that eliminated the ability of third parties to perform implementation services. Similarly, the Company determined that these implementation services are not a separate performance obligation under Topic 606 for contracts entered into after July 1, 2018 and the associated implementation fees are treated as nonrefundable upfront fees which are deferred and amortized over a period of time instead of recognized upon completion. The Company recognized $2,191, net of deferred taxes, of contract assets for implementation fees related to open contracts as of July 1, 2018, which began when the Company was still able to establish stand-alone value for implementation activities. This adjustment was recorded through retained earnings (accumulated deficit) in the statement of changes in stockholder’s equity upon adoption on July 1, 2018.

The Company also finalized the treatment of costs of obtaining and fulfilling a new contract under the new standard. The Company is now required to defer these costs and amortize them over the expected period of benefit, which it has determined to be 7 years. The Company recognized the cumulative effect related to the deferral of the costs of obtaining new contracts of $50,481, net of deferred taxes, which was recorded through retained earnings (accumulated deficit) in the statement of changes in stockholder’s equity upon adoption on July 1, 2018.

The cumulative effect of the changes made to the July 1, 2018 balance sheet due to the adoption of Topic 606 were as follows:

	As Reported June 30, 2018	Adjustments due to Topic 606	Balances at July 1, 2018
Balance Sheet			
Assets			
Deferred contract costs	$ —	$ 14,783	$ 14,783
Prepaid expenses and other	11,248	1,730	12,978
Long-term deferred contract costs	—	53,324	53,324
Long-term prepaid expenses and other	1,504	1,226	2,730
Deferred income tax assets, net	22,140	(18,391)	3,749
Stockholders' Equity			
Retained earnings (accumulated deficit)	(6,678)	52,672	45,994

The following tables summarize the impact from the adoption of Topic 606 on the Company’s unaudited consolidated statements of operations and comprehensive income:

	Three Months Ended December 31, 2018		
	As Reported (Topic 606)	Balances under ASC 605	Impact from Adoption
Statement of Operations			
Revenues			
Recurring fees	$ 100,275	$ 100,711	$ (436)
Implementation services and other	2,464	1,298	1,166
Cost of Revenues			
Implementation services and other	6,864	12,214	(5,350)
Operating expenses			
Sales and marketing	26,570	28,085	(1,515)
General and administrative	22,739	22,861	(122)
Income tax expense (benefit)	1,669	(329)	1,998
Net income	5,704	(16)	5,720

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	Six Months Ended December 31, 2018		
	As Reported (Topic 606)	Balances under ASC 605	Impact from Adoption
Statement of Operations			
Revenues			
Recurring fees	$ 196,036	$ 196,908	$ (872)
Implementation services and other	3,705	2,098	1,607
Cost of Revenues			
Implementation services and other	13,575	24,170	(10,595)
Operating expenses			
Sales and marketing	52,988	56,294	(3,306)
General and administrative	45,707	45,962	(255)
Income tax expense (benefit)	(4,138)	(7,992)	3,854
Net income	15,556	4,519	11,037

The following table summarizes the impact from the adoption of Topic 606 on the Company’s unaudited consolidated balance sheet:

	December 31, 2018		
	As Reported (Topic 606)	Balances under ASC 605	Impact from Adoption
Balance Sheet			
Assets			
Deferred contract costs	$ 17,665	$ —	$ 17,665
Prepaid expenses and other	12,553	10,926	1,627
Long-term deferred contract costs	64,598	—	64,598
Long-term prepaid expenses and other	3,266	2,809	457
Deferred income tax assets, net	7,891	30,136	(22,245)
Liabilities			
Accrued expenses	43,207	41,338	1,869
Other long-term liabilities	1,595	5,071	(3,476)
Stockholders' Equity			
Retained earnings (accumulated deficit)	61,550	(2,159)	63,709

The following table summarizes the impact from the adoption of Topic 606 on the Company’s unaudited consolidated statement of cash flows:

	Six Months Ended December 31, 2018		
	As Reported (Topic 606)	Balances under ASC 605	Impact from Adoption
Statement of Cash Flows			
Net income	$ 15,556	$ 4,519	$ 11,037
Adjustments to reconcile net income to net cash provided by operating activities:			
Deferred income tax expense (benefit)	(4,139)	(7,993)	3,854
Changes in operating assets and liabilities:			
Deferred contract costs	(14,156)	—	(14,156)
Prepaid expenses and other	635	(237)	872
Accrued expenses	1,027	2,634	(1,607)
Net cash provided by operating activities	34,296	34,296	—

In March 2018, the FASB issued ASU 2018-05, Income Taxes (Topic 740) (“ASU 2018-05”) which incorporates the SEC’s Staff Accounting Bulletin 118 (“SAB 118”) issued on December 22, 2017. SAB 118 provides for

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a provisional measurement period for entities to finalize their accounting for certain income tax effects related to the Tax Cuts and Jobs Act (the “Act”), not to exceed one year from enactment of the new tax law. Entities are permitted to utilize reasonable estimates until they have finished analyzing the effects of the Act. The Company recognized provisional income tax effects of the Act during fiscal 2018 in accordance with SAB 118, and completed its accounting under the Act in December 2018. Refer to Note 8 for additional information.

(f) Recently Issued Accounting Standards

In February 2016, the FASB established Topic 842, Leases, by issuing ASU 2016-02, which requires lessees to recognize leases on-balance sheet and disclose key information about leasing arrangements. Topic 842 was subsequently amended by ASU 2018-01, Land Easement Practical Expedient for Transition to Topic 842; ASU 2018-10, Codification Improvements to Topic 842, Leases; and ASU 2018-11, Targeted Improvements. The new standard establishes a right-of-use model (“ROU”) that requires a lessee to recognize a ROU asset and lease liability on the balance sheet for all leases with a term longer than 12 months. Leases will be classified as finance or operating, with classification affecting the pattern and classification of expense recognition in the income statement.

The new standard is effective on July 1, 2019, with early adoption permitted. A modified retrospective transition approach is required, applying the new standard to all leases existing at the date of initial application. An entity may choose to use either (1) its effective date or (2) the beginning of the earliest comparative period presented in the financial statements as its date of initial application. If an entity chooses the second option, the transition requirements for existing leases also apply to leases entered into between the date of initial application and the effective date. The entity must also recast its comparative period financial statements and provide the disclosures required by the new standard for the comparative periods. The Company expects to adopt the new standard on July 1, 2019 and use the effective date as the date of initial application. Consequently, financial information will not be updated and the disclosures required under the new standard will not be provided for dates and periods before July 1, 2019.

While the Company continues to assess all of the effects of adoption, it currently believes the most significant effects relate to (1) the recognition of new ROU assets and lease liabilities on the balance sheet for operating leases; and (2) providing significant new disclosures about leasing activities. The Company expects to elect the ‘package of practical expedients’, which permits the Company not to reassess under the new standard the prior conclusions about lease identification, lease classification and initial direct costs.

In August 2018, the FASB issued ASU 2018-13, Fair Value Measurement (Topic 820): Disclosure Framework – Changes to the Disclosure Requirements for Fair Value Measurement (“ASU 2018-13”), which amends the requirements for fair value measurement disclosures. ASU 2018-13 removes, modifies or adds certain disclosure requirements under GAAP. This standard is effective for fiscal years beginning after December 15, 2019, with early adoption permitted. Any new disclosure requirements must be applied on a prospective basis in the interim and annual periods of initial adoption; all removed or modified requirements must be applied retrospectively to all periods presented. The Company is assessing the impact of ASU 2018-13 including the timing and method of adoption.

From time to time, new accounting pronouncements are issued by the FASB or other standard setting bodies that are adopted by the Company as of the specified effective date. Unless otherwise discussed, the Company believes that the impact of other recently issued standards that are not yet effective will not have a material impact on the Company's consolidated financial statements upon adoption.

(3) Balance Sheet Information

The following tables provide details of selected consolidated balance sheet items:

Activity in the allowance for doubtful accounts was as follows:

Balance at June 30, 2018	$ 375
Charged to expense	112
Write-offs	(103)
Balance at December 31, 2018	$ 384

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Capitalized internal-use software and accumulated amortization were as follows:

	June 30, 2018	December 31, 2018
Capitalized internal-use software	$ 67,678	$ 78,377
Accumulated amortization	(46,584)	(55,214)
Capitalized internal-use software, net	$ 21,094	$ 23,163

Amortization of capitalized internal-use software costs is included in Cost of Revenues-Recurring Revenues and amounted to $3,314 and $4,418 for the three months ended December 31, 2017 and 2018, respectively, and $6,703 and $8,630 for the six months ended December 31, 2017 and 2018, respectively.

Property and equipment, net consist of the following:

	June 30, 2018	December 31, 2018
Office equipment	$ 3,743	$ 4,505
Computer equipment	29,768	33,371
Furniture and fixtures	10,382	10,571
Software	5,965	6,231
Leasehold improvements	36,366	38,043
Time clocks rented by clients	4,534	4,619
Total	90,758	97,340
Accumulated depreciation	(28,729)	(34,678)
Property and equipment, net	$ 62,029	$ 62,662

Depreciation expense amounted to $3,092 and $3,588 for the three months ended December 31, 2017 and 2018, respectively, and $6,017 and $7,045 for the six months ended December 31, 2017 and 2018, respectively.

The Company’s amortizable intangible assets and estimated useful lives are as follows:

	June 30, 2018	December 31, 2018	Useful Life
Client relationships	$ 18,130	$ 18,130	7 - 9 years
Non-solicitation agreements	600	600	2 - 4 years
Total	18,730	18,730	
Accumulated amortization	(5,728)	(6,854)	
Intangible assets, net	$ 13,002	$ 11,876	

Amortization expense for acquired intangible assets was $359 and $563 for the three months ended December 31, 2017 and 2018, respectively, and $718 and $1,126 for the six months ended December 31, 2017 and 2018, respectively.

Future amortization expense for acquired intangible assets is as follows, as of December 31, 2018:

Remainder of fiscal 2019	$ 1,125
Fiscal 2020	2,251
Fiscal 2021	2,251
Fiscal 2022	2,232
Fiscal 2023	2,118
Thereafter	1,899
Total	$ 11,876

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The components of accrued expenses were as follows:

	June 30, 2018	December 31, 2018
Accrued payroll and personnel costs	$ 31,206	$ 28,825
Lease exit obligations	2,143	1,468
Other	8,892	12,914
Total accrued expenses	$ 42,241	$ 43,207

In June 2018, the Company ceased using approximately 110 rentable square feet of its former headquarters in Arlington Heights, Illinois in conjunction with relocating to its new Schaumburg, Illinois headquarters. The following table is a summary of the changes in the remaining lease exit obligations related to the Company's former headquarters, which is recorded in accrued expenses and other long-term liabilities on the unaudited consolidated balance sheets:

Balance at June 30, 2018	$ 3,261
Payments	(1,211)
Adjustments	69
Balance at December 31, 2018	$ 2,119

(4) Corporate Investments and Funds Held for Clients

Corporate investments and funds held for clients consist of the following:

	June 30, 2018			
Type of Issue	Amortized cost	Gross unrealized gains	Gross unrealized losses	Fair value
Cash and cash equivalents	$ 137,193	$ —	$ —	$ 137,193
Funds held for clients' cash and cash equivalents	1,102,541	—	(3)	1,102,538

Available-for-sale securities:				
Commercial paper	50,703	3	(4)	50,702
Corporate bonds	37,508	8	(134)	37,382
Asset-backed securities	25,901	1	(55)	25,847
U.S. treasury securities	9,879	—	(2)	9,877
Total available-for-sale securities (1)	123,991	12	(195)	123,808
Total investments	$ 1,363,725	$ 12	$ (198)	$ 1,363,539

(1) Included within the fair value of total available-for-sale securities above is $732 of corporate investments and $123,076 of funds held for clients

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	December 31, 2018			
Type of Issue	Amortized cost	Gross unrealized gains	Gross unrealized losses	Fair value
Cash and cash equivalents	$ 84,114	$ —	$ —	$ 84,114
Funds held for clients' cash and cash equivalents	1,126,731	—	(1)	1,126,730
Available-for-sale securities:				
Commercial paper	60,749	—	(18)	60,731
Corporate bonds	36,597	4	(102)	36,499
Asset-backed securities	39,544	3	(60)	39,487
U.S. treasury securities	16,170	—	(15)	16,155
Total available-for-sale securities (2)	153,060	7	(195)	152,872
Total investments	$ 1,363,905	$ 7	$ (196)	$ 1,363,716

(2) Included within the fair value of total available-for-sale securities above is $20,829 of corporate investments and $132,043 of funds held for clients

The Company began investing corporate funds in available-for-sale securities during the first quarter of fiscal 2019 and as a result, reclassified $732 as of June 30, 2018 from prepaid expenses and other on the unaudited consolidated balance sheets to corporate investments for comparability purposes in order to conform to the current year's presentation. Cash and cash equivalents and funds held for clients' cash and cash equivalents include demand deposit accounts, money market funds and commercial paper as of June 30, 2018 and December 31, 2018.

Classification of investments on the unaudited consolidated balance sheets is as follows:

	June 30, 2018	December 31, 2018
Cash and cash equivalents	$ 137,193	$ 84,114
Corporate investments	732	19,934
Funds held for clients	1,225,614	1,258,773
Long-term prepaid expenses and other	—	895
Total investments	$ 1,363,539	$ 1,363,716

Available-for-sale securities that have been in an unrealized loss position for a period of less and greater than 12 months are as follows:

	June 30, 2018					
	Securities in an unrealized loss position for less than 12 months		Securities in an unrealized loss position for greater than 12 months		Total	
	Gross unrealized losses	Fair value	Gross unrealized losses	Fair value	Gross unrealized losses	Fair value
Commercial paper	$ (4)	$ 23,657	$ —	$ —	$ (4)	$ 23,657
Corporate bonds	(134)	29,122	—	—	(134)	29,122
Asset-backed securities	(55)	17,960	—	—	(55)	17,960
U.S. treasury securities	(2)	4,933	—	—	(2)	4,933
Total available-for-sale securities	$ (195)	$ 75,672	$ —	$ —	$ (195)	$ 75,672

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	December 31, 2018					
	Securities in an unrealized loss position for less than 12 months		Securities in an unrealized loss position for greater than 12 months		Total	
	Gross unrealized losses	Fair value	Gross unrealized losses	Fair value	Gross unrealized losses	Fair value
Commercial paper	$ (18)	$ 50,265	$ —	$ —	$ (18)	$ 50,265
Corporate bonds	(64)	23,393	(38)	10,301	(102)	33,694
Asset-backed securities	(37)	27,925	(23)	4,038	(60)	31,963
U.S. treasury securities	(15)	16,156	—	—	(15)	16,156
Total available-for-sale securities	$ (134)	$ 117,739	$ (61)	$ 14,339	$ (195)	$ 132,078

The Company regularly reviews the composition of its portfolio to determine the existence of other-than-temporary-impairment (“OTTI”). The Company did not recognize any OTTI charges in accumulated other comprehensive loss during the three or six months ended December 31, 2017 or 2018, nor does it believe that OTTI exists in its portfolio as of December 31, 2018. The Company plans to retain the securities in an unrealized loss position for a period of time sufficient enough to recover their amortized cost basis or until their maturity date. The Company believes that the unrealized losses on these securities were not due to deterioration in credit risk. The securities in an unrealized loss position held an A-1 rating or better as of December 31, 2018.

The Company did not make any material reclassification adjustments out of accumulated other comprehensive loss for realized gains and losses on the sale of available-for-sale securities during the three or six months ended December 31, 2017 or 2018. Gross realized gains and losses on the sale of available-for-sale securities were immaterial for both the three and six months ended December 31, 2017 and 2018.

Expected maturities of available-for-sale securities at December 31, 2018 are as follows:

	Amortized cost	Fair value
One year or less	$ 141,790	$ 141,636
One year to two years	9,770	9,750
Two years to three years	1,500	1,486
Total available-for-sale securities	$ 153,060	$ 152,872

(5) Fair Value Measurement

The Company applies the fair value measurement and disclosure provisions of ASC 820, Fair Value Measurements and Disclosures, and ASU 2011-04, Fair Value Measurement (Topic 820): Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRS. Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. A three-level fair value hierarchy prioritizes the inputs used to measure fair value. The hierarchy requires entities to maximize the use of observable inputs and minimize the use of unobservable inputs. The three levels of inputs used to measure fair value are as follows:

· Level 1—Quoted prices in active markets for identical assets and liabilities.

· Level 2—Quoted prices in active markets for similar assets and liabilities, or other inputs that are observable for the asset or liability, either directly or indirectly, for substantially the full term of the financial instrument.

· Level 3—Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets and liabilities. This includes certain pricing models, discounted cash flow methodologies and similar techniques that use significant unobservable inputs.

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The Company measures certain cash and cash equivalents, accounts receivable, accounts payable and client fund obligations at fair value on a recurring basis using Level 1 inputs. The Company considers the recorded value of these financial assets and liabilities to approximate the fair value of the respective assets and liabilities at June 30, 2018 and December 31, 2018 based upon the short-term nature of these assets and liabilities.

Marketable securities, consisting of securities classified as available-for-sale as well as certain cash equivalents, are recorded at fair value on a recurring basis using Level 2 inputs obtained from an independent pricing service. Available-for-sale securities include commercial paper, corporate bonds, asset-backed securities and U.S. treasury securities. The independent pricing service utilizes a variety of inputs including benchmark yields, broker/dealer quoted prices, reported trades, issuer spreads as well as other available market data. The Company, on a sample basis, validates the pricing from the independent pricing service against another third-party pricing source for reasonableness. The Company has not adjusted any prices obtained by the independent pricing service, as it believes they are appropriately valued. There were no available-for-sale securities classified in Level 3 of the fair value hierarchy at June 30, 2018 or December 31, 2018, and the Company did not transfer assets between Levels during the six months ended December 31, 2017 or 2018.

The fair value level for the Company’s cash and cash equivalents and available-for-sale securities is as follows:

	June 30, 2018			
	Total	Level 1	Level 2	Level 3
Cash and cash equivalents	$ 137,193	$ 137,193	$ —	$ —
Funds held for clients' cash and cash equivalents	1,102,538	1,076,414	26,124	—
Available-for-sale securities:				
Commercial paper	50,702	—	50,702	—
Corporate bonds	37,382	—	37,382	—
Asset-backed securities	25,847	—	25,847	—
U.S. treasury securities	9,877	—	9,877	—
Total available-for-sale securities	123,808	—	123,808	—
Total investments	$ 1,363,539	$ 1,213,607	$ 149,932	$ —

	December 31, 2018			
	Total	Level 1	Level 2	Level 3
Cash and cash equivalents	$ 84,114	$ 79,327	$ 4,787	$ —
Funds held for clients' cash and cash equivalents	1,126,730	1,108,906	17,824	—
Available-for-sale securities:				
Commercial paper	60,731	—	60,731	—

Corporate bonds	36,499	—	36,499	—
Asset-backed securities	39,487	—	39,487	—
U.S. treasury securities	16,155	—	16,155	—
Total available-for-sale securities	152,872	—	152,872	—
Total investments	$ 1,363,716	$ 1,188,233	$ 175,483	$ —

The Company began investing corporate funds in available-for-sale securities during the first quarter of fiscal 2019 and as a result, reclassified $732 as of June 30, 2018 from prepaid expenses and other on the unaudited consolidated balance sheets to corporate investments for comparability purposes in order to conform to the current year's presentation.

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(6) Benefit Plans

(a) Equity Incentive Plan

The Company maintains a 2008 Equity Incentive Plan (the "2008 Plan") and a 2014 Equity Incentive Plan (the "2014 Plan") pursuant to which the Company has reserved shares of its common stock for issuance to its employees, directors and non-employee third parties. The 2014 Plan serves as the successor to the 2008 Plan and permits the granting of options to purchase common stock and other equity incentives at the discretion of the compensation committee of the Company's board of directors. No new awards have been or will be issued under the 2008 Plan since the effective date of the 2014 Plan. Outstanding awards under the 2008 Plan continue to be subject to the terms and conditions of the 2008 Plan. The number of shares of common stock reserved for issuance under the 2014 Plan will increase automatically each calendar year, continuing through and including January 1, 2024. The number of shares added each year will be equal to the lesser of (a) four and five tenths percent (4.5%) of the number of shares of common stock of the Company issued and outstanding on the immediately preceding December 31, or (b) an amount determined by the Company's board of directors.

As of December 31, 2018, the Company had 13,256 shares allocated to the plans, of which 3,591 shares were subject to outstanding options or awards. Generally, the Company issues previously unissued shares for the exercise of stock options or vesting of awards; however, shares previously subject to 2014 Plan grants or awards that are forfeited or net settled at exercise or release may be reissued to satisfy future issuances.

The following table summarizes changes in the number of shares available for grant under the Company's equity incentive plans during the six months ended December 31, 2018:

	Number of Shares
Available for grant at July 1, 2018	10,030
RSUs granted	(736)
Shares withheld in settlement of taxes and/or exercise price	303
Forfeitures	115
Shares removed	(47)
Available for grant at December 31, 2018	9,665

Shares removed represents forfeitures of shares and shares withheld in settlement of taxes and/or payment of exercise price related to grants made under the 2008 Plan. As noted above, no new awards will be issued under the 2008 Plan.

Stock-based compensation expense related to stock options, restricted stock units (“RSUs”), and the Employee Stock Purchase Plan (as described below) is included in the following line items in the accompanying unaudited consolidated statements of operations and comprehensive income:

	Three Months Ended December 31,		Six Months Ended December 31,	
	2017	2018	2017	2018
Cost of revenue – recurring	$ 734	$ 883	$ 1,356	$ 1,735
Cost of revenue – implementation services and other	377	421	749	807
Sales and marketing	2,205	2,000	4,143	3,697
Research and development	945	1,460	1,816	2,738
General and administrative	3,557	5,335	6,360	10,547
Total stock-based compensation expense	$ 7,818	$ 10,099	$ 14,424	$ 19,524

In addition, the Company capitalized $471 and $696 of stock-based compensation expense in its capitalized internal-use software costs in the three months ended December 31, 2017 and 2018, respectively, and $904 and $1,321 in the six months ended December 31, 2017 and 2018, respectively.

Under the 2008 and 2014 Plans, the exercise price of each option cannot be less than the fair value of a share of common stock on the grant date. The options typically vest ratably over a three or four year period and expire 10 years

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from the grant date. Stock-based compensation expense for the fair value of the options at their grant date is recognized ratably over the vesting schedule for each separately vesting portion of the award.

There were no stock options granted during the six months ended December 31, 2017 or 2018. The table below presents stock option activity during the six months ended December 31, 2018:

	Outstanding Options			
	Number of shares	Weighted average exercise price	Weighted average remaining contractual term (years)	Aggregate intrinsic value
Balance at July 1, 2018	1,907	$ 12.40	5.00	$ 88,595
Options forfeited	(2)	$ 26.14		
Options exercised	(212)	$ 12.52		
Balance at December 31, 2018	1,693	$ 12.37	4.50	$ 80,989
Options exercisable at December 31, 2018	1,665	$ 11.99	4.46	$ 80,306
Options vested and expected to vest at December 31, 2018	1,692	$ 12.36	4.49	$ 80,967

The total intrinsic value of options exercised was $23,875 and $1,501 during the three months ended December 31, 2017 and 2018, respectively, and $27,255 and $13,704 during the six months ended December 31, 2017 and 2018, respectively. At December 31, 2018, there was $60 of total unrecognized compensation cost, net of estimated forfeitures, related to unvested stock options granted under the Plan. That cost is expected to be recognized over a weighted average period of 0.62 years.

The Company may also grant RSUs under the 2014 Plan with terms determined at the discretion of the compensation committee of the Company’s board of directors. RSUs generally vest over four years following the grant date. Certain RSU awards have time-based vesting conditions while other RSUs vest based on the achievement of certain revenue growth and Adjusted EBITDA margin targets in future fiscal years. The following table represents restricted stock unit activity during the six months ended December 31, 2018:

	Units	Weighted average grant date fair value
RSU balance at July 1, 2018	1,879	$ 43.39
RSUs granted	736	$ 66.26

RSUs vested	(604)	$ 41.01
RSUs forfeited	(113)	$ 46.17
RSU balance at December 31, 2018	1,898	$ 52.86
RSUs expected to vest at December 31, 2018	1,720	$ 52.68

At December 31, 2018, there was $53,147 of total unrecognized compensation cost, net of estimated forfeitures, related to unvested restricted stock units granted. That cost is expected to be recognized over a weighted average period of 1.95 years.

(b) Employee Stock Purchase Plan

Under the Company's Employee Stock Purchase Plan ("ESPP"), the Company can grant stock purchase rights to all eligible employees during specific offering periods not to exceed twenty-seven months. Each offering period will begin on the trading day closest to May 16 and November 16 of each year. Shares are purchased through employees' payroll deductions, up to a maximum of 10% of employees' compensation for each purchase period, at a purchase price equal to 85% of the lesser of the fair market value of the Company's common stock at the first trading day of the applicable offering period or the purchase date. Participants may purchase up to $25 worth of common stock or 2 shares of common stock in any one year. The ESPP is considered compensatory and results in compensation expense.

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As of December 31, 2018, a total of 1,053 shares of common stock were reserved for future issuances under the ESPP. The number of shares of common stock reserved for issuance under the ESPP will increase automatically each calendar year, continuing through and including January 1, 2024. The number of shares added each year will be equal to the lesser of (a) 400, (b) seventy-five one hundredths percent (0.75%) of the number of shares of common stock of the Company issued and outstanding on the immediately preceding December 31, or (c) an amount determined by the Company's board of directors.

The Company issued 58 shares upon the completion of its six-month offering period ending November 15, 2018. The Company recorded compensation expense attributable to the ESPP of $309 and $446 for the three months ended December 31, 2017 and 2018, respectively, and $648 and $885 for the six months ended December 31, 2017 and 2018, respectively, which is included in the summary of stock-based compensation expense above. The grant date fair value of the ESPP offering periods was estimated using the following weighted average assumptions:

	Six Months Ended December 31,			
	2017		2018	
Valuation assumptions:				
Expected dividend yield	0	%	0	%
Expected volatility	28.3 - 39.1	%	33.5 - 38.3	%
Expected term (years)	0.5		0.5	
Risk free interest rate	1.02 - 1.35	%	2.10 - 2.48	%

(c) 401(k) Plan

The Company maintains a 401(k) plan with a matching provision that covers all eligible employees. The Company matches 50% of employees' contributions up to 8% of their gross pay. Contributions were $995 and $1,140 for the three months ended December 31, 2017 and 2018, respectively, and $2,106 and $2,534 for the six months ended December 31, 2017 and 2018, respectively.

(7) Net Income Per Share

Basic net income per common share is computed using the weighted average number of common shares outstanding during the period. Diluted net income per share is computed using the weighted average number of common shares outstanding during the period and, if dilutive, potential common shares outstanding during the period. The Company's potential common shares consist of the incremental common shares issuable upon the exercise of stock options, the release of restricted stock units, and the shares purchasable via the employee stock purchase plan as of the balance sheet date. The following table presents the calculation of basic and diluted net income per share:

	Three Months Ended December 31,		Six Months Ended December 31,	
	2017	2018	2017	2018
Numerator:				
Net income	$ 431	$ 5,704	$ 974	$ 15,556
Denominator:				
Weighted-average shares used in computing net income per share:				
Basic	52,502	52,842	52,197	52,853
Weighted-average effect of potentially dilutive shares:				
Employee stock options and restricted stock units	2,316	2,239	2,442	2,379
Diluted	54,818	55,081	54,639	55,232
Net income per share:				
Basic	$ 0.01	$ 0.11	$ 0.02	$ 0.29
Diluted	$ 0.01	$ 0.10	$ 0.02	$ 0.28

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The following table summarizes the outstanding restricted stock units and employee stock purchase plan shares as of the balance sheet date that were excluded from the diluted per share calculation for the periods presented because to include them would have been anti-dilutive:

	Three Months Ended December 31,		Six Months Ended December 31,	
	2017	2018	2017	2018
Restricted stock units	5	25	795	687
Employee stock purchase plan shares	15	17	15	17
Total	20	42	810	704

In August 2018, the Company announced that its board of directors approved a program to repurchase up to $35,000 of the Company's common stock, with authorization through August 14, 2019. The Company completed the repurchase program during the first quarter of fiscal 2019 and repurchased 442 shares for $34,991. All shares of common stock repurchased were retired.

(8) Income Taxes

The Company's quarterly provision for income taxes is based on the annual effective rate method. The Company's quarterly provision for income taxes also includes the tax impact of certain unusual or infrequently occurring items, if any, including changes in judgment about valuation allowances and effects of changes in tax laws or rates, and other discrete items in the interim period in which they occur.

The Company recorded income tax expense (benefit) of $(157) and $1,669 for the three months ended December 31, 2017 and 2018, respectively, and $(76) and $(4,138) for the six months ended December 31, 2017 and 2018, respectively. The Company's effective tax rates for the three and six months ended December 31, 2017 differed from statutory rates primarily due to the existence of a valuation allowance recorded against the preponderance of the net deferred tax assets. The Company's effective tax rates for the three and six months ended December 31, 2018 differed from statutory rates primarily due to excess tax benefits from employee stock exercises partially offset by various permanent adjustments.

The Company reviews the likelihood that it will realize the benefit of its deferred tax assets and, therefore, the need for a valuation allowance on a quarterly basis. The Company established a valuation allowance in fiscal 2014 on all of its net deferred tax assets except for deferred tax liabilities associated with indefinite-lived intangible assets, given that the Company determined that it was more likely than not that the Company would not recognize the benefits of its net operating loss carryforwards prior to their expiration. The Company continued to record a valuation allowance through the first six months of fiscal 2018. In the third quarter of fiscal 2018, management concluded that all of the valuation allowance for the Company's U.S. federal deferred tax assets and substantially all state deferred tax assets was no longer needed. This was primarily due to three years' cumulative income through the third quarter of fiscal 2018 and the forecast of future taxable income. As of March 31, 2018, based on the evaluation of positive and negative evidence, management believed it was more likely than not that the net deferred tax assets would be realized for all federal and state purposes with the exception of deferred tax assets associated with certain state tax credits that have a limited carryforward period. As of December 31, 2018, the Company continued to maintain a valuation allowance of $355 for state tax benefits. Such assessment may change in the future as further evidence becomes available.

On December 22, 2017, the Tax Cuts and Jobs Act of 2017 was signed into law. Over the long term, the Company generally expects to benefit from the lower statutory rates provided by the Act. The Company operates solely in the United States; therefore, the international provisions of the Act do not apply. In accordance with ASC 740, during the second quarter of fiscal 2018, the Company modified its current federal statutory rate for the year to account for the rate change.

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In December 2017, the staff of the SEC issued guidance under Staff Accounting Bulletin No. 118 (later codified into ASU 2018-05), “Income Tax Accounting Implications of the Tax Cuts and Jobs Act,” allowing taxpayers to record provisional amounts for reasonable estimates when they do not have the necessary information available, prepared or analyzed in reasonable detail to complete their accounting for certain income tax effects of the Tax Act. The SEC also issued rules that would allow for a measurement period of up to one year after the enactment date of the Tax Act to finalize the related tax impacts. The Company’s analysis is now complete with no additional adjustments made for the three months ended December 31, 2018.

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

The statements included herein that are not based solely on historical facts are "forward looking statements." Such forward-looking statements are based on current expectations and assumptions that are subject to risks and uncertainties. Our actual results could differ materially from those anticipated by us in these forward-looking statements as a result of various factors, including those discussed below and under Part II, Item 1A: "Risk Factors."

Overview

We are a cloud-based provider of payroll and human capital management ("HCM") software solutions for medium-sized organizations, which we define as those having between 20 and 1,000 employees. Our comprehensive and easy-to-use solutions enable our clients to manage their workforces more effectively. Our solutions help drive strategic human capital decision-making and improve employee engagement by enhancing the human resource, payroll and finance capabilities of our clients.

Effective management of human capital is a core function in all organizations and requires a significant commitment of resources. Medium-sized organizations operating without the infrastructure, expertise or personnel of larger enterprises are uniquely pressured to manage their human capital effectively.

Our solutions were specifically designed to meet the payroll and HCM needs of medium-sized organizations. We designed our cloud-based platform to provide a unified suite of applications using a multi-tenant architecture. Our solutions are highly flexible and configurable and feature a modern, intuitive user experience. Our platform offers automated data integration with over 300 related third-party systems, such as 401(k), benefits and insurance provider systems.

Our Paylocity Web Pay product is our core payroll solution and was the first of our current offerings introduced into the market. We believe payroll is the most critical system of record for medium-sized organizations and an essential gateway to other HCM functionalities. We have invested in, and we intend to continue to invest in, research and development to expand our product offerings and advance our platform.

We believe there is a significant opportunity to grow our business by increasing our number of clients, and we intend to invest in our business to achieve this purpose. We market and sell our solutions primarily through our direct sales force. We have increased our sales and marketing expenses as we have added sales representatives and related sales and marketing personnel. We intend to continue to grow our sales and marketing organization across new and existing geographic territories. In addition to growing our number of clients, we intend to grow our revenue over the long term by increasing the number and quality of products that clients purchase from us. To do so, we must continue to enhance and grow the number of solutions we offer to advance our platform.

We believe that delivering a positive service experience is an essential element of our ability to sell our solutions and retain our clients. We seek to develop deep relationships with our clients through our unified service model, which has been designed to meet the service needs of mid-market organizations. We expect to continue to invest in and grow our implementation and client service organization as our client base grows.

We believe we have the opportunity to continue to grow our business over the long term, and to do so, we have invested, and intend to continue to invest, across our entire organization. These investments include increasing the number of personnel across all functional areas, along with improving our solutions and infrastructure to support our growth. The timing and amount of these investments vary based on the rate at which we add new clients, add new personnel and scale our application development and other activities. Many of these investments will occur in advance of experiencing any direct benefit from them, which will make it difficult to determine if we are effectively allocating our resources. We expect these investments to increase our costs on an absolute basis, but as we grow our number of clients and our related revenues, we anticipate that we will gain economies of scale and increased operating leverage. As a result, we expect our gross and operating margins will improve over the long term.

As our business has grown, we have become increasingly subject to the risks arising from adverse changes in domestic and global economic conditions. If general economic conditions were to deteriorate, including declines in private sector employment growth and business productivity, increases in the unemployment rate and changes in interest

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rates, we may experience delays in our sales cycles, increased pressure from prospective customers to offer discounts and increased pressure from existing customers to renew expiring recurring revenue agreements for lower amounts.

Paylocity Holding Corporation is a Delaware corporation, which was formed in November 2013. Our business operations, excluding interest earned on certain cash holdings and expenses associated with certain secondary stock offerings, have historically been, and are currently, conducted by its wholly owned subsidiaries, and the financial results presented herein are entirely attributable to the results of such wholly owned subsidiaries' operations.

Key Metrics

We regularly review a number of metrics, including the following key metrics, to evaluate our business, measure our performance, identify trends affecting our business, formulate financial projections and make strategic decisions.

Recurring Revenue Growth

Our recurring revenue model and high annual revenue retention rates provide significant visibility into our future operating results and cash flow from operations. This visibility enables us to better manage and invest in our business. Recurring revenue, which is comprised of recurring fees and interest income on funds held for clients, increased from $83.1 million for the three months ended December 31, 2017 to $104.7 million for the three months ended December 31, 2018, representing a 26% year-over year increase. Recurring revenue increased from $162.0 million for the six months ended December 31, 2017 to $204.0 million for the six months ended December 31, 2018, representing a 26% year-over-year increase. Recurring revenue represented 97% and 98% of total revenue during both the three months and six months ended December 31, 2017 and 2018, respectively.

Adjusted Gross Profit, Adjusted Recurring Gross Profit and Adjusted EBITDA

We disclose Adjusted Gross Profit, Adjusted Recurring Gross Profit and Adjusted EBITDA because we use them to evaluate our performance, and we believe Adjusted Gross Profit, Adjusted Recurring Gross Profit and Adjusted EBITDA assist in the comparison of our performance across reporting periods by excluding certain items that we do not believe are indicative of our core operating performance. We believe these metrics are used in the financial community, and we present them to enhance investors' understanding of our operating performance and cash flows.

Adjusted Gross Profit, Adjusted Recurring Gross Profit and Adjusted EBITDA are not measurements of financial performance under generally accepted accounting principles in the United States, or GAAP, and you should not consider Adjusted Gross Profit as an alternative to gross profit, Adjusted Recurring Gross Profit as an alternative to total recurring revenues, or Adjusted EBITDA as an alternative to net income or cash provided by operating activities, in each case as determined in accordance with GAAP. In addition, our definition of Adjusted Gross Profit, Adjusted Recurring Gross Profit and Adjusted EBITDA may be different than the definition utilized for similarly-titled measures used by other companies.

We define Adjusted Gross Profit as gross profit before amortization of capitalized internal-use software costs, stock-based compensation expense and employer payroll taxes related to stock releases and option exercises. We define Adjusted Recurring Gross Profit as total recurring revenues after cost of recurring revenues and before amortization of capitalized internal-use software costs, stock-based compensation expense and employer payroll taxes related to stock releases and option exercises. We define Adjusted EBITDA as net income before interest expense, income tax expense (benefit), depreciation and amortization expense and stock-based compensation expense and employer payroll taxes related to stock releases and option exercises. The table below sets forth our Adjusted Gross Profit, Adjusted Recurring Gross Profit and Adjusted EBITDA for the periods presented.

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	Three Months Ended December 31,		Six Months Ended December 31,	
	2017	2018	2017	2018
	(in thousands)		(in thousands)	
Adjusted Gross Profit	$ 53,621	$ 74,871	$ 104,732	$ 145,241
Adjusted Recurring Gross Profit	$ 61,504	$ 78,837	$ 120,450	$ 154,165
Adjusted EBITDA	$ 15,245	$ 26,100	$ 29,837	$ 49,363

	Three Months Ended December 31,		Six Months Ended December 31,	
	2017	2018	2017	2018
	(in thousands)		(in thousands)	
Reconciliation from Gross Profit to Adjusted Gross Profit				
Gross profit	$ 49,164	$ 69,134	$ 95,705	$ 133,696
Amortization of capitalized internal-use software costs	3,314	4,418	6,703	8,630
Stock-based compensation expense and employer payroll taxes related to stock releases and option exercises	1,143	1,319	2,324	2,915
Adjusted Gross Profit	$ 53,621	$ 74,871	$ 104,732	$ 145,241

	Three Months Ended December 31,		Six Months Ended December 31,	
	2017	2018	2017	2018