Benefitfocus,Inc.
Form 10-Q
May 08, 2018

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 March 31, 2018

or

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from to .

Commission File Number: 001-36061

Benefitfocus, Inc.

(Exact name of registrant as specified in its charter)

Delaware	46-2346314
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

100 Benefitfocus Way

Charleston, South Carolina 29492

(Address of principal executive offices and zip code)

(843) 849-7476

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, 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:

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

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

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

As of May 1, 2018, there were approximately 31,762,092 shares of the registrant's common stock outstanding.

Benefitfocus, Inc.

Form 10-Q

For the Quarterly Period Ended March 31, 2018

TABLE OF CONTENTS

PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

Benefitfocus, Inc.

Unaudited Consolidated Balance Sheets

(in thousands, except share and per share data)

	As of March 31, 2018	As of December 31, 2017
Assets		
Current assets:		
Cash and cash equivalents	$54,785	$55,335
Accounts receivable, net	29,678	30,091
Contract, prepaid and other current assets	15,077	15,859
Total current assets	99,540	101,285
Property and equipment, net	71,233	72,681
Intangible assets, net	86	150
Goodwill	1,634	1,634
Deferred contract costs and other non-current assets	15,262	16,253
Total assets	$187,755	$192,003
Liabilities and stockholders' deficit		
Current liabilities:		
Accounts payable	$5,557	$4,260
Accrued expenses	10,599	9,110
Accrued compensation and benefits	11,288	14,250
Deferred revenue, current portion	36,167	43,804
Revolving line of credit, current portion	24,000	24,000
Financing and capital lease obligations, current portion	3,716	3,423
Total current liabilities	91,327	98,847
Deferred revenue, net of current portion	16,733	11,223
Revolving line of credit, net of current portion	39,246	32,246
Financing and capital lease obligations, net of current portion	55,724	55,597
Other non-current liabilities	2,699	2,809
Total liabilities	205,729	200,722
Commitments and contingencies		
Stockholders' deficit:		
Preferred stock, par value $0.001, 5,000,000 shares authorized, no shares issued and outstanding at March 31, 2018 and December 31, 2017	–	–
Common stock, par value $0.001, 50,000,000 shares authorized,	31	31

31,339,469 and 31,307,989 shares issued and outstanding at March 31, 2018 and December 31, 2017, respectively		
Additional paid-in capital	357,043	352,496
Accumulated deficit	(375,048)	(361,246)
Total stockholders' deficit	(17,974)	(8,719)
Total liabilities and stockholders' deficit	$187,755	$192,003

The accompanying notes are an integral part of the Unaudited Consolidated Financial Statements.

Benefitfocus, Inc.

Unaudited Consolidated Statements of Operations and Comprehensive Loss

(in thousands, except share and per share data)

	Three Months Ended March 31, 2018	2017
Revenue	$62,363	$57,623
Cost of revenue	31,403	32,202
Gross profit	30,960	25,421
Operating expenses:		
Sales and marketing	19,917	18,023
Research and development	12,023	12,181
General and administrative	9,693	7,757
Total operating expenses	41,633	37,961
Loss from operations	(10,673)	(12,540)
Other expense:		
Interest income	58	27
Interest expense on building lease financing obligations	(1,866)	(1,860)
Interest expense on other borrowings	(1,317)	(1,062)
Other expense	–	(148)
Total other expense, net	(3,125)	(3,043)
Loss before income taxes	(13,798)	(15,583)
Income tax expense	4	–
Net loss	$(13,802)	$(15,583)
Comprehensive loss	$(13,802)	$(15,583)
Net loss per common share:		
Basic and diluted	$(0.44)	$(0.51)
Weighted-average common shares outstanding:		
Basic and diluted	31,333,348	30,658,468

The accompanying notes are an integral part of the Unaudited Consolidated Financial Statements.

Benefitfocus, Inc.

Unaudited Consolidated Statement of Changes in Stockholders' Deficit

(in thousands, except share and per share data)

	Common Stock, $0.001 Par Value Shares	Par Value	Additional Paid-in Capital	Accumulated Deficit	Total Stockholders' Deficit
Balance, December 31, 2017 (as previously reported)	31,307,989	$ 31	$ 355,301	$ (394,663)	$ (39,331)
Adoption of revenue recognition standard	–	–	(2,805)	33,417	30,612
Balance, December 31, 2017	31,307,989	31	$ 352,496	$ (361,246)	$ (8,719)
Exercise of stock options	9,250	–	42	—	42
Issuance of common stock upon vesting of restricted stock units	15,208	—	–	—	–
Issuance of common stock under Employee Stock Purchase Plan, or ESPP	7,022	—	180	—	180
Stock-based compensation expense	—	—	4,325	—	4,325
Net loss	—	—	—	(13,802)	(13,802)
Balance, March 31, 2018	31,339,469	$ 31	$ 357,043	$ (375,048)	$ (17,974)

The accompanying notes are an integral part of the Unaudited Consolidated Financial Statements.

Benefitfocus, Inc.

Unaudited Consolidated Statements of Cash Flows

(in thousands)

	Three Months Ended March 31, 2018			2017		
Cash flows from operating activities						
Net loss	$	(13,802	)	$	(15,583	)
Adjustments to reconcile net loss to net cash and cash equivalents used in operating activities:						
Depreciation and amortization		3,930			4,005	
Stock-based compensation expense		4,325			4,388	
Interest accrual on financing obligation		1,879			1,873	
Loss on disposal or impairment of property and equipment		–			148	
Provision for doubtful accounts		359			22	
Changes in operating assets and liabilities:						
Accounts receivable, net		54			5,654	
Accrued interest on short-term investments		–			7	
Contract, prepaid and other current assets		881			1,092	
Deferred contract costs and other non-current assets		1,166			1,945	
Accounts payable and accrued expenses		2,722			(1,039	)
Accrued compensation and benefits		(2,962	)		(6,593	)

Deferred revenue		(2,127	)		(3,110	)
Other non-current liabilities		(108	)		(222	)
Net cash and cash equivalents used in operating activities		(3,683	)		(7,413	)
Cash flows from investing activities						
Proceeds from maturity of short-term investments held to maturity		–			2,000	
Purchases of property and equipment		(1,641	)		(2,103	)
Net cash and cash equivalents used in investing activities		(1,641	)		(103	)
Cash flows from financing activities						
Draws on revolving line of credit		31,000			28,000	
Payments on revolving line of credit		(24,000	)		(20,000	)
Proceeds from exercises of stock options and ESPP		222			2,454	
Payments on financing and capital lease obligations		(2,448	)		(2,120	)
Net cash and cash equivalents provided by financing activities		4,774			8,334	
Net (decrease) increase in cash and cash equivalents		(550	)		818	
Cash and cash equivalents, beginning of period		55,335			56,853	
Cash and cash equivalents, end of period	$	54,785		$	57,671	
Supplemental disclosure of non-cash investing and financing activities						
	$	452		$	200	

Property and equipment purchases in accounts payable and accrued expenses				
Property and equipment purchased with financing and capital lease obligations	$	713	$	—
Post contract support purchased with financing obligations	$	275	$	—

The accompanying notes are an integral part of the Unaudited Consolidated Financial Statements.

BENEFITFOCUS, INC.

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

(in thousands, except share and per share data)

1. Organization and Description of Business

Benefitfocus, Inc. (the “Company”) provides a leading cloud-based benefits management platform for consumers, employers, insurance carriers and brokers under a software-as-a-service (“SaaS”) model. The financial statements of the Company include the financial position and operations of its wholly owned subsidiaries, Benefitfocus.com, Inc. and BenefitStore, Inc.

2. Summary of Significant Accounting Policies

Principles of Consolidation

These consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles (“GAAP”). The consolidated financial statements include the accounts of the Company and its wholly owned subsidiaries. All intercompany accounts and transactions have been eliminated in consolidation. We are not the primary beneficiary of, nor do we have a controlling financial interest in, any variable interest entity. Accordingly, we have not consolidated any variable interest entity.

Interim Unaudited Consolidated Financial Information

The accompanying unaudited consolidated financial statements and footnotes have been prepared in accordance with GAAP as contained in the Financial Accounting Standards Board (“FASB”) Accounting Standards Codification (the “Codification” or “ASC”) for interim financial information, and with Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes 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 results of operations, financial position, changes in stockholders’ equity and cash flows. The results of operations for the three-month period ended March 31, 2018 are not necessarily indicative of the results for the full year or for any other future period. These unaudited consolidated financial statements should be read in conjunction with the audited financial statements and related footnotes for the year ended December 31, 2017 included in the Company’s Annual Report on Form 10-K, as amended.

Use of Estimates

The preparation of financial statements in conformity with GAAP requires the Company to make estimates and assumptions that affect the reported amounts in the consolidated financial statements and accompanying notes. Such estimates include, allowances for doubtful accounts and returns, valuations of deferred income taxes, long-lived assets, capitalizable software development costs and the related amortization, stock-based compensation, the determination of the useful lives of assets, the impairment assessment of goodwill as well as the estimates disclosed in association with revenue recognition. Determination of these transactions and account balances are based on the Company’s estimates and judgments. These estimates are based on the Company’s knowledge of current events and actions it may undertake in the future as well as on various other assumptions that it believes to be reasonable. Actual results could differ materially from these estimates.

Revenue

The Company derives its revenues primarily from software services fees and professional services fees sold to employers and insurance carriers. Revenues are recognized when control of these services is transferred to customers, in an amount that reflects the consideration we expect to be entitled to in exchange for those services. Taxes collected from customers relating to services and remitted to governmental authorities are excluded from revenues.

The Company determines revenue recognition through the following steps:

- Identification of the contract, or contracts, with a customer;
- Identification of the performance obligations in the contract;
- Determination of the transaction price;
- Allocation of the transaction price to the performance obligations in the contract; and
- Recognition of revenue when, or as, performance obligations are satisfied.

Software Services Revenues

Software services revenues primarily consist of monthly subscription fees paid to the Company by its employer and insurance carrier customers for access to, and usage of, cloud-based benefits software solutions for a specified contract term. Fees are generally charged based on the number of employees or subscribers with access to the solution. Software services revenue also includes insurance broker commissions from the sale of voluntary and ancillary benefits policies to employees of the Company's customers.

Software services revenues are generally recognized on a ratable basis over the contract term beginning on the date the software services are made available to the customer. The Company's software service contracts are generally three years for both carrier and employer customers. Revenue from insurance broker commissions is recognized when the orders for the policies are received and transferred to the insurance carrier.

Professional Services Revenues

Professional services revenues primarily consist of fees related to the implementation of software products purchased by customers. Professional services typically include discovery, configuration and deployment, integration, testing, and training. Fees from consulting services, support services and training are also included in professional services revenue.

Revenue from implementation services with customers in the Carrier segment are generally recognized over the contract term of the associated software services contract, including any extension periods representing a material right.

Revenues from implementation services with customers in the Employer segment are generally recognized as those services are performed.

Revenues from support and training fees are recognized over the service contract period.

Contracts with Multiple Performance Obligations

Certain of the Company's contracts with customers contain multiple performance obligations. For these contracts, the individual performance obligations are accounted for separately if they are distinct. The transaction price is allocated to the separate performance obligations on a relative standalone selling price basis. The Company determines the standalone selling prices based on its overall pricing objectives, taking into consideration market conditions and other factors, including the value of its contracts, the software services sold, customer size and complexity, and the number and types of users within the contracts.

Practical Expedients Elected

In addition to practical expedients disclosed elsewhere in the notes to unaudited consolidated financial statements, the Company has elected to use the practical expedient not to adjust the promised amount of consideration for the effects of a significant financing component for contracts in which the period between transferring a service to a customer and when the customer pays for that service is one year or less.

Contract Costs

The Company capitalizes costs to obtain contracts that are considered incremental and recoverable, such as sales commissions. Payments of sales commissions generally include multiple payments. The Company capitalizes only those payments made within an insignificant time from the contract inception, typically three months. Subsequent payments are expensed as incurred. The capitalized costs are amortized to sales and marketing expense over the estimated period of benefit of the asset, which is generally four to five years. The Company has elected to use the practical expedient to expense the costs to obtain a contract when the amortization period is less than one year. The balance of deferred costs related to obtaining contracts included in deferred contract costs and other non-current assets was $7,097 and $7,376 as of March 31, 2018 and December 31, 2017, respectively. Sales and marketing expense includes $1,102 and $1,162 of amortization for the three months ended March 31, 2018 and 2017, respectively.

The Company capitalizes contract fulfillment costs directly associated with customer contracts that are not related to satisfying performance obligations. The costs are amortized to cost of revenue expense over the estimated period of benefit, which is generally five years. The balance of deferred fulfillment costs included in deferred contract costs and other non-current assets was $7,191 and $8,060 as of March 31, 2018 and December 31, 2017, respectively. Cost of revenue expense includes $895 and $853 of amortization for the three months ended March 31, 2018 and 2017, respectively.

Concentrations of Credit Risk

The Company's financial instruments that are exposed to concentrations of credit risk consist primarily of cash equivalents and accounts receivable. All of the Company's cash and cash equivalents are held at financial institutions that management believes to be of high credit quality. The bank deposits of the Company might, at times, exceed federally insured limits and are generally uninsured and uncollateralized. The Company has not experienced any losses on cash and cash equivalents to date.

To manage accounts receivable risk, the Company evaluates the creditworthiness of its customers and maintains an allowance for doubtful accounts. Accounts receivable are unsecured and derived from revenue earned from customers located in the United States. Accounts receivable from one customer represented approximately 13% and 12% of the total accounts receivable as of March 31, 2018 and December 31, 2017, respectively. Revenue from one customer was approximately 12% and 11% of the total revenue in the three-month period ended March 31, 2018 and 2017, respectively.

Accounts Receivable and Allowance for Doubtful Accounts and Returns

Accounts receivable are stated at realizable value, net of allowances for doubtful accounts and returns. The Company utilizes the allowance method to provide for doubtful accounts based on management's evaluation of the collectability of amounts due, and other relevant factors. Bad debt expense is recorded in general and administrative expense on the consolidated statements of operations and comprehensive loss. The Company's estimate is based on historical collection experience and a review of the current status of accounts receivable. Historically, actual write-offs for uncollectible accounts have not significantly differed from the Company's estimates. The Company removes recorded receivables and the associated allowances when they are deemed permanently uncollectible. However, if bad debts are higher than expected, future write-offs will be greater than the Company's estimates. The allowance for doubtful accounts was $897 and $654 as of March 31, 2018 and December 31, 2017, respectively.

The allowances for returns are accounted for as reductions of revenue and are estimated based on the Company's periodic assessment of historical experience and trends. The Company considers factors such as the time lag since the initiation of revenue recognition, historical reasons for adjustments, new customer volume, complexity of billing arrangements, timing of software availability, and past due customer billings. The allowance for returns was $3,667 and $2,877 as of March 31, 2018 and December 31, 2017, respectively.

Capitalized Software Development Costs

The Company capitalizes certain costs related to its software developed or obtained for internal use. Costs related to preliminary project activities and post-implementation activities are expensed as incurred. Internal and external costs incurred during the application development stage, including upgrades and enhancements representing modifications that will result in significant additional functionality, are capitalized. Software maintenance and training costs are expensed as incurred. Capitalized costs are recorded as part of property and equipment and are amortized on a straight-line basis to cost of revenue over the software's estimated useful life, which is three years. The Company evaluates these assets for impairment whenever events or changes in circumstances occur that could impact the recoverability of these assets.

In the three months ended March 31, 2018 and 2017, the Company capitalized software development costs of $1,280 and $1,227, respectively, and amortized capitalized software development costs of $889 and $831, respectively. The net book value of capitalized software development costs was $8,052 and $7,660 at March 31, 2018 and December 31, 2017, respectively.

Comprehensive Loss

The Company's net loss equals comprehensive loss for all periods presented.

Recently Adopted Accounting Standards

Revenue from Contracts with Customers

On January 1, 2018, the Company adopted Accounting Standards Update ("ASU") No. 2014-09, "Revenue from Contracts with Customers (Topic 606)," applying the full retrospective transition method to all contracts that were not completed as of January 1, 2016, the initial date of application.

The adoption of Topic 606 significantly affected the accounting for revenue from certain professional services in the Carrier segment and insurance broker commission revenue included in software services revenue in the Employer segment.

Prior to the adoption of Topic 606, the Company recognized revenue from certain professional services in the Carrier segment over the customer relationship period. Under Topic 606, revenue from certain of these services are recognized over the contract term of the associated software services contract, including any extension periods representing a material right which is typically shorter than the customer relationship period. The financial statement impact of this change is a reduction to the deferred revenue balance as of the date of adoption.

Also prior to the adoption of Topic 606, the Company recognized insurance broker commission revenue over the policy period. Under Topic 606, the revenue related to broker commissions is recognized when the orders for the policies are received and transferred to the insurance carrier. As a result, software services revenue from these arrangements in the Employer segment is recognized in the aggregate and earlier under Topic 606 in comparison to the previous treatment. The financial statement impact of this change is reductions to balances of deferred revenue and increases in contract asset balances reported in other non-current assets.

Additionally, prior to the adoption of Topic 606, the Company recognized revenue from implementation services fees that are paid in advance in the Employer segment either when the associated software services are made available to the customer or over the customer relationship period. Under the new standard, revenue from these fees are recognized as the services are provided on a percentage complete basis. The financial statement impact of this change is revenue from these fees being recognized sooner under the new standard.

In connection with the adoption of Topic 606, the Company is required to capitalize costs associated with obtaining and fulfilling a contract. Contract assets recognized for costs to obtain a contract consist primarily of sales commissions associated with obtaining contracts in the Carrier segment. These assets are amortized to sales and marketing expense over the estimated period of benefit of the asset, which is generally four to five years. Contract assets recognized for costs to fulfill a contract consist primarily of internal costs related to implementing products in the Carrier segment. These assets are amortized to cost of revenue expense over the estimated period of benefit, which is generally five years.

The Company used the practical expedient for contracts that were completed by January 1, 2018, the initial date of application of Topic 606, which allows for the use of the transaction price at the date the contract was completed for contracts restated in comparative reporting periods, rather than estimating the variable consideration amount in each comparative reporting period.

The following tables show the amounts by which financial statement lines were affected by the adoption of Topic 606.

Financial Statement Line Item	As of December 31, 2017 As previously reported	Adjustments	As adjusted
Consolidated Balance Sheet			
Accounts receivable, net	$30,156	$ (65)	$30,091
Contract, prepaid and other current assets	4,337	11,522	15,859
Deferred contract costs and other non-current assets	816	15,437	16,253
Accrued expenses	9,136	(26)	9,110
Deferred revenue, current portion	38,821	4,983	43,804
Deferred revenue, net of current portion	19,898	(8,675)	11,223
Additional paid-in capital	355,301	(2,805)	352,496
Accumulated deficit	(394,663)	33,417	(361,246)

Financial Statement Line Item	Three Months Ended March 31, 2017 As previously reported	Adjustments	As adjusted
Consolidated Statement of Operations and Comprehensive Loss			
Revenue	$64,171	$ (6,548)	$57,623
Cost of revenue	31,601	601	32,202
Sales and marketing	17,277	746	18,023
Loss from operations	(4,645)	(7,895)	(12,540)
Net loss and comprehensive loss	(7,688)	(7,895)	(15,583)
Net loss per common share: Basic and diluted	$(0.25)	$ (0.26)	$(0.51)

Cash provided by, or used in, operating, investing and financing activities were not affected by the adoption of Topic 606.

Accounting Standards Not Yet Adopted

In June 2016, the FASB issued ASU No. 2016-13, “Financial Instruments – Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments.” The purpose of this ASU is to require a financial asset measured at amortized cost basis to be presented at the net amount expected to be collected. Credit losses relating to available-for-sale debt securities should be recorded through an allowance for credit losses. This ASU is effective for interim and annual reporting periods starting January 1, 2020. The Company is currently evaluating the impact of this guidance on its consolidated financial statements.

In February 2016, the FASB issued ASU No. 2016-02, “Leases (Topic 842).” The amendments in this update require lessees, among other things, to recognize lease assets and lease liabilities on the balance sheet for those leases classified as operating leases under previous authoritative guidance. This update also introduces new disclosure requirements for leasing arrangements. ASU 2016-02 will be effective for the Company beginning January 1, 2019. Early adoption is permitted. The Company is currently evaluating the impact of this update on its consolidated financial statements.

3. Net Loss Per Common Share

Diluted loss per common share is the same as basic loss per common share for all periods presented because the effects of potentially dilutive items were anti-dilutive given the Company's net loss. The following common share equivalent securities have been excluded from the calculation of weighted average common shares outstanding because the effect is anti-dilutive for the periods presented:

	Three Months Ended	
	March 31,	
Anti-Dilutive Common Share Equivalents	2018	2017
Restricted stock units	1,730,065	1,597,423
Stock options	253,905	409,038
Warrant to purchase common stock	-	580,813
Employee Stock Purchase Plan	4,358	3,063
Total anti-dilutive common share equivalents	1,988,328	2,590,337

Basic and diluted net loss per common share is calculated as follows:

	Three Months Ended	
	March 31,	
	2018	2017
Numerator:		
Net loss	$(13,802)	$(15,583)
Net loss attributable to common stockholders	$(13,802)	$(15,583)
Denominator:		
Weighted-average common shares outstanding, basic and diluted	31,333,348	30,658,468
Net loss per common share, basic and diluted	$(0.44)	$(0.51)

4. Fair Value Measurement

The carrying amounts of certain of the Company's financial instruments, including cash and cash equivalents, net accounts receivable, accounts payable and other accrued liabilities, and accrued compensation and benefits, approximate fair value due to their short-term nature. The carrying value of the Company's financing obligations and revolving line of credit approximates fair value, considering the borrowing rates currently available to the Company with similar terms and credit risks.

The Company uses a three-tier fair value hierarchy to classify and disclose all assets and liabilities measured at fair value on a recurring basis, as well as assets and liabilities measured at fair value on a non-recurring basis, in periods subsequent to their initial measurement. The hierarchy requires the Company to use observable inputs when available, and to minimize the use of unobservable inputs when determining fair value. The three tiers are defined as follows:

Level 1. Quoted prices (unadjusted) in active markets for identical assets or liabilities.
Level 2. Other inputs that are directly or indirectly observable in the marketplace.
Level 3. Unobservable inputs for which there is little or no market data, which require the Company to develop its own assumptions.

Assets and Liabilities Measured at Fair Value on a Recurring Basis

The Company evaluates its financial assets and liabilities subject to fair value measurements on a recurring basis to determine the appropriate level to classify them for each reporting period. This determination requires significant judgments to be made.

The following tables present information about the Company's assets and liabilities that are measured at fair value on a recurring basis using the above categories, as of the periods presented.

	March 31, 2018			
Description	Level 1	Level 2	Level 3	Total
Cash Equivalents:				
Money market mutual funds (1)	$47,986	$ —	$ —	$47,986

Total assets	$47,986	$ —	$ —	$47,986

Description	December 31, 2017			
	Level 1	Level 2	Level 3	Total
Cash Equivalents:				
Money market mutual funds (1)	$46,730	$ —	$ —	$46,730
Total assets	$46,730	$ —	$ —	$46,730

(1) Money market funds are classified as cash equivalents in the Company's unaudited consolidated balance sheets. As short-term, highly liquid investments readily convertible to known amounts of cash with remaining maturities of three months or less at the time of purchase, the Company's cash equivalent money market funds have carrying values that approximate fair value.

5. Revolving Line of Credit

On March 29, 2018, the Company amended its revolving line of credit agreement. The amendment altered definitions in the revolving line of credit agreement, including Consolidated EBITDA and Recurring Revenue, and changes the Minimum Consolidated EBITDA requirements. The amendment was entered into to modify the above terms and requirements to account for the Company's adoption of Topic 606.

As of March 31, 2018 and December 31, 2017, the amount outstanding under the Company's revolving line of credit was $63,246 and $56,246, respectively. As of March 31, 2018, the additional amount available to borrow, adjusted by the borrowing base limit, was $12,343 and the interest rate was 5.75%.

In January 2018, the Company repaid $24,000 of the amount outstanding under its line of credit and borrowed $7,000 under its line of credit for general operating purposes. In March 2018, the Company borrowed $24,000 under its line of credit for general operating purposes.

6. Stock-based Compensation

Restricted Stock Units

On January 1, 2018, the Company granted 54,040 restricted stock units, or RSUs, to employees and officers with an aggregate grant date fair value of $1,456. These RSUs generally vest in equal annual installments over the 4 years from the grant date. The Company amortizes the grant date fair value of the stock subject to the RSUs on a straight-line basis over the period of vesting.

On March 15, 2018, the Company granted 28,602 RSUs to employees with an aggregate grant date fair value of $674. The RSUs vest on April 1, 2018. The Company recognized the grant date fair value of the stock subject to the RSUs during March 2018.

On March 29, 2018 in connection with the Company's incentive bonus programs, the Company granted 52,889 RSUs and 186,188 performance RSUs to officers with an aggregate grant date fair value of $1,290 and $4,543, respectively. The aggregate grant date fair value of the performance RSUs assuming target achievement was $3,233. Vesting of the performance RSUs is contingent upon meeting specific financial, revenue and sales related growth targets through December 31, 2018. The actual number of shares issued upon vesting of the performance restricted stock units could range from 0% to 100% of the number granted. The awards will vest in equal annual installments over 4 years starting April 1, 2019, except for 25,112 performance RSUs, which will vest in the first quarter of 2019.

7. Stockholders' Deficit

Common Stock

The holders of common stock are entitled to one vote for each share. The voting, dividend and liquidation rights of the holders of common stock are subject to and qualified by the rights, powers and preferences of the holders of preferred stock.

At March 31, 2018, the Company had reserved a total of 4,938,616 of its authorized 50,000,000 shares of common stock for future issuance as follows:

Outstanding stock options	253,905
Restricted stock units	1,730,065
Available for future issuance under stock award plans	2,824,195
Available for future issuance under ESPP	130,451
Total common shares reserved for future issuance	4,938,616

8. Revenue

Disaggregation of Revenue

The following table provides information about disaggregation of revenue by service line and includes a reconciliation of disaggregated revenue with reportable segments:

	Three Months Ended March 31, 2018			Three Months Ended March 31, 2017		
	Employer	Carrier	Total	Employer	Carrier	Total
Service line:						
Software services	$30,313	$17,857	$48,170	$29,026	$17,475	$46,501
Professional services	9,971	4,222	14,193	6,811	4,311	11,122
Total	$40,284	$22,079	$62,363	$35,837	$21,786	$57,623

12

Contract Balances

The following table provides information about contract assets and contract liabilities from contracts with customers:

	Balance at Beginning of Period	Balance at End of Period
Three Months Ended March 31, 2018		
Contract assets	$ 11,522	$9,329
Contract liabilities:		
Deferred revenue	$ 55,027	$52,900
Three Months Ended March 31, 2017		
Contract assets	$ 15,929	$13,447
Contract liabilities:		
Deferred revenue	$ 56,949	$53,839

The Company recognizes payments from customers based on contractual billing schedules. Accounts receivable are recorded when the right to consideration becomes unconditional. Contract assets include amounts related to the Company's contractual right to consideration for completed performance objectives not yet invoiced. Contract liabilities include payments received in advance of performance under the contract and are recognized as revenue when earned under the contract. The Company had no asset impairment charges related to contract assets during the three months ended March 31, 2018 and 2017.

The following table shows the significant changes in contract asset balances:

	Three Months Ended March 31, 2018	2017
Contact Assets:		
Transferred to receivables from contract assets recognized at beginning of period	$4,865	$3,628
Revenue recognized from performance obligations satisfied but not billed	$2,757	$1,201

Performance Obligations

As of March 31, 2018, the aggregate amount of the Company's performance obligations that are unsatisfied or partially unsatisfied were approximately $220,000, of which a majority are expected to be satisfied within the next three years. The Company excludes from its population of performance obligations contracts with original durations of one year or less, contract renewal periods that renew automatically, or amounts of variable consideration that are allocated to wholly unsatisfied distinct service that forms part of a single performance obligation and meets certain variable allocation criteria.

9. Income Taxes

The Company's effective federal tax rate for the three months ended March 31, 2018 was less than one percent, primarily as a result of estimated tax losses for the fiscal year to date offset by the increase in the valuation allowance in the net operating loss carryforwards. Current tax expense relates to estimated state income taxes.

The Company has not completed its accounting for the income tax effects of the enactment of the Tax Cuts & Jobs Act ("Tax Reform") on December 22, 2017 with respect to the impact of state tax conformity of each change and further evaluation of executive compensation. The Company is not able to determine a reasonable estimate for these items and continues to account for these items based on the tax laws that were in effect immediately before the enactment of Tax Reform.

10. Segments and Geographic Information

Operating segments are defined as components of an enterprise for which discrete financial information is available that is evaluated regularly by the chief operating decision maker ("CODM") for purposes of allocating resources and evaluating financial performance. The Company's CODM, the Chief Executive Officer, reviews financial information presented on a consolidated basis, accompanied by information about operating segments, for purposes of allocating resources and evaluating financial performance.

The Company's reportable segments are based on the type of customer. The Company determined its operating segments to be: Employer, which derives substantially all of its revenue from customers that use the Company's services for the provision of benefits to their employees, and administrators acting on behalf of employers; and Carrier, which derives substantially all of its revenue from insurance companies that provide coverage at their own risk.

Segments are evaluated based on gross profit. The Company does not allocate interest income, interest expense or income tax expense by segment. Accordingly, the Company does not report such information. Additionally, Employer and Carrier segments share the majority of the Company's assets. Therefore, no segment asset information is reported.

	Three Months Ended March 31,	
	2018	2017
Revenue from external customers by segment:		
Employer	$40,284	$35,837
Carrier	22,079	21,786
Total net revenue from external customers	$62,363	$57,623
Depreciation and amortization by segment:		
Employer	$2,518	$2,510
Carrier	1,412	1,495
Total depreciation and amortization	$3,930	$4,005
Gross profit by segment:		
Employer	$17,618	$11,943
Carrier	13,342	13,478
Total gross profit	$30,960	$25,421

11. Related Parties

Related Party Leasing Arrangements

The Company leases its office space at its Charleston, South Carolina headquarters campus under the terms of three non-cancellable leases from entities with which an executive and two of the Company's directors and significant stockholders are affiliated. The Company's headquarters building lease and an additional building lease are accounted for as build-to-suit leases and recorded as financing obligations in the Consolidated Balance Sheets. The remaining lease, also for office space, is accounted for as a capital lease. The three lease agreements have 15-year terms ending on December 31, 2031, with Company options to renew for five additional years. The arrangements provide for 3.0% fixed annual rent increases. Payments under these agreements were $3,326 and $3,209 for the three months ended March 31, 2018 and 2017, respectively. Other amounts due to the related parties were $236 and $901 as of March 31, 2018 and December 31, 2017, respectively, and were recorded in "Accrued expenses."

In March 2018, the Company's landlord extended the time period to commence construction of additional office space under its December 12, 2016 lease. Under the extension, the Company agrees to commence construction on or about April 1, 2019 and the target commencement date extends one year to July 1, 2020. The Company can terminate the lease prior to April 1, 2019.

Other Related Party Expenses

The Company utilizes the services of various companies that are owned and controlled by a Company director, significant stockholder, and executive. The companies provide construction project management services, private air transportation and other services. Expenses related to these companies were $13 and $19 for the three months ended March 31, 2018 and 2017, respectively. There were no amounts due to these companies as of March 31, 2018 or December 31, 2017.

Related Party Revolving Line of Credit

In conjunction with an amendment to the Company's revolving line of credit agreement in October 2016, Goldman Sachs Lending Partners, LLC was added to the lending syndicate. Goldman Sachs Lending Partners, LLC is an affiliate of The Goldman Sachs Group, Inc., as are the Goldman Sachs funds that owned approximately 19.9% of the Company's outstanding common stock as of March 31, 2018. Goldman Sachs Lending Partners, LLC committed $10,000 to the revolving commitment and therefore loans the Company approximately 10.5% of all amounts borrowed under the credit facility. Accordingly, amounts due to Goldman Sachs Lending Partners, LLC was approximately $6,641 of the $63,246 outstanding under the revolving line of credit as of March 31, 2018 and $5,906 of the $56,246 outstanding under the revolving line of credit as of December 31, 2017.

12. Subsequent Events

Restricted Stock Units

On April 1, 2018, the Company granted 266,713 RSUs and 622,779 performance RSUs with an aggregate grant date fair value of $6,214 and $14,511, respectively. The aggregate grant date fair value of the performance RSUs assuming target achievement was $10,114. The RSUs generally vest in equal annual installments of over four years from the grant date. The number of performance RSUs that will vest will be determined upon the achievement of certain financial targets for 2018, and vesting will then occur in equal annual installments over various periods ranging from one to four years. The actual number of shares issued upon vesting could range between 0% and 100% of the number of awards granted. The weighted average vesting period was 3.7 years as of the grant date.

Common Stock

During April 2018, employees exercised stock options and RSUs vested resulting in the issuance of 467,926 shares.

Revolving Line of Credit

In April 2018, the Company repaid $24,000 under its revolving line of credit.

SPECIAL NOTE REGARDING FORWARD-LOOKING STATEMENTS

This Quarterly Report on Form 10-Q 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. The statements contained in this Quarterly Report on Form 10-Q that are not purely historical are forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, or Securities Act, and Section 21E of the Securities Exchange Act of 1934, as amended, or Exchange Act. Such forward-looking statements include any expectation of earnings, revenue or other financial items; any statements of the plans, strategies and objectives of management for future operations; factors that may affect our operating results; statements about our ability to retain and hire necessary associates and appropriately staff our operations; statements about our ability to establish and maintain intellectual property rights; statements related to future capital expenditures; statements related to future economic conditions or performance; statements as to industry trends; and other matters that do not relate strictly to historical facts or statements of assumptions underlying any of the foregoing. 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,” “might,” “will,” “plan,” “project,” “ “would,” and similar expressions or variations intended to identify forward-looking statements. These statements are based on the beliefs and assumptions of our management based on information currently available to management. 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 discussed in the section titled “Risk Factors” included in Item 1A of Part II of this Quarterly Report on Form 10-Q, and the risks discussed in our other SEC filings. 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 statements.

As used in this report, the terms “Benefitfocus, Inc.,” “Benefitfocus,” “Company,” “company,” “we,” “us,” and “our” mean Benefitfocus, Inc. and its subsidiaries unless the context indicates otherwise.

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 and with the financial statements, related notes and Management’s Discussion and Analysis of Financial Condition and Results of Operations in our Annual Report on Form 10-K, as amended, for the fiscal year ended December 31, 2017. The following discussion contains forward-looking statements that reflect our plans, estimates and beliefs. Our actual results could differ materially from those discussed in the forward-looking statements. Factors that could cause or contribute to such differences include, but are not limited to, those discussed in the section titled “Risk Factors” included in Item 1A of Part II of this Quarterly Report on Form 10-Q, and the risks discussed in our other SEC filings.

Overview

Benefitfocus provides a leading cloud-based benefits management platform for consumers, employers, insurance carriers, and brokers. The Benefitfocus Platform simplifies how organizations and individuals shop for, enroll in, manage, and exchange benefits. Our employer and insurance carrier customers rely on our platform to manage, scale, and exchange data. Our web-based platform has a user-friendly interface designed to enable the insured consumers to access all of their benefits in one place. Our comprehensive solutions support core benefits plans, including healthcare, dental, life, and disability insurance, and voluntary benefits offerings such as income protection, digital health, and financial wellness. As the number of employer benefits plans has increased, with each plan subject to many different business rules and requirements, demand for the Benefitfocus Platform has grown.

We serve two separate but related market segments. The employer market consists of employers offering benefits to their employees. Within this segment, we mainly target large employers with more than 1,000 employees, of which we believe there are over 18,000 in the United States. In our other market segment, we sell our solutions to insurance carriers, enabling us to expand our overall footprint in the benefits marketplace by aggregating many key constituents, including consumers, employers, and brokers. Our business model capitalizes on the close relationship between carriers and their members, and the carriers’ ability to serve as lead generators for potential employer customers. Carriers pay for services at a rate reflective of the aggregated nature of their customer base on a per application basis. Carriers can then deploy their applications to employer groups and members. As employers become direct customers through our Employer segment, we provide them our platform offering that bundles many software applications into a comprehensive benefits solution through Benefitfocus Marketplace. We believe our presence in both the employer and insurance carrier markets gives us a strong position at the center of the benefits ecosystem.

We sell the Benefitfocus Platform on a subscription basis, typically through multi-year contracts with employer and insurance carrier customers, with subscription fees paid monthly, quarterly, and annually. The multi-year contracts with our carrier customers are generally only cancellable by the carrier in an instance of our uncured breach, although some of our carrier customers are able to terminate their respective contracts without cause or for convenience. Software services revenue accounted for approximately 77% and 81% of our total revenue during the three-month periods ended March 31, 2018 and 2017, respectively.

Another component of our revenue is professional services. We derive the majority of our professional services revenue from the implementation of our customers onto our platform, which typically includes discovery, configuration and deployment, integration, testing, and training. In general, it takes from four to six months to implement a new employer customer’s benefits systems and eight to 10 months to implement a new carrier customer’s benefits systems. We also provide customer support services and customized media content that supports our customers’ effort to educate and communicate with consumers. Professional services revenue accounted for approximately 23% and 19% of our total revenue during the three-month periods ended March 31, 2018 and 2017, respectively.

Increasing our base of large employer customers is an important source of revenue growth for us. We actively pursue new employer customers in the U.S. market, and we have increased the number of large employer customers utilizing our solutions from 141, as of December 31, 2010, to 948 as of March 31, 2018, a 31.3% compound annual growth rate. We believe that our continued innovation and new solutions, such as online benefits marketplaces, also known as private exchanges, account services, enhanced mobile offerings, and more robust data analytics capabilities will help us attract additional large employer customers and increase our revenue from existing customers.

We believe that there is a substantial market for our services, and we have been investing in growth over the past six years. In particular, we have continued to invest in technology and services to better serve our larger employer customers, which we believe are an important source of growth for our business. We have also substantially increased our marketing and sales efforts and expect those increased efforts to continue. As we have invested in growth, we have had a history of operating losses, and expect our operating losses to continue for at least the next year. Due to the nature of our customer relationships, which have been stable in spite of some customer losses over the past years, and the subscription nature of our financial model, we believe that our current investment in growth should lead to substantially increased revenue, which will allow us to achieve profitability in the relatively near future. Of course, our ability to achieve profitability will continue to be subject to many factors beyond our control.

Key Financial and Operating Performance Metrics

We regularly monitor a number of financial and operating metrics in order to measure our current performance and project our future performance. These metrics help us develop and refine our growth strategies and make strategic decisions. We discuss revenue, gross margin, and the components of operating loss, as well as segment revenue and segment gross profit, in “Management’s

Discussion and Analysis of Financial Condition and Results of Operations—Components of Operating Results". In addition, we utilize other key metrics as described below.

Number of Large Employer and Carrier Customers

We believe the number of large employer and carrier customers is a key indicator of our market penetration, growth, and future revenue. We have aggressively invested in and intend to continue to invest in our sales function to grow our customer base. We generally define a customer as an entity with an active software services contract as of the measurement date. The following table sets forth the number of large employer and carrier customers for the periods indicated:

	As of March 31,	
	2018	2017
Number of customers:		
Large employer	948	853
Carrier	55	53

Software Services Revenue Retention Rate

We believe that our ability to retain our customers and expand the revenue they generate for us over time is an important component of our growth strategy and reflects the long-term value of our customer relationships. We measure our performance on this basis using a metric we refer to as our software services revenue retention rate. We calculate this metric for a particular period by establishing the group of our customers that had active contracts for a given period. We then calculate our software services revenue retention rate by taking the amount of software services revenue we recognized for this group in the subsequent comparable period (for which we are reporting the rate) and dividing it by the software services revenue we recognized for the group in the prior period.

For the three-month periods ended March 31, 2018 and 2017, our software services revenue retention rate exceeded 95%.

Adjusted EBITDA

Adjusted EBITDA represents our earnings before net interest and other expenses, taxes, and depreciation and amortization expense, adjusted to eliminate stock-based compensation and impairment of goodwill and intangible assets and costs not core to our business. We believe that the exclusion of the expenses eliminated in calculating adjusted EBITDA can provide a useful measure for period-to-period comparisons of our core business. Accordingly, we believe that adjusted EBITDA provides useful information to investors and others in understanding and evaluating our operating results. However, adjusted EBITDA is not a measure calculated in accordance with United States generally accepted accounting principles, or GAAP, and should not be considered as an alternative to any measure of financial performance calculated and presented in accordance with GAAP.

Our use of adjusted EBITDA as an analytical tool has limitations, and you should not consider it in isolation or as a substitute for analysis of our financial results as reported under GAAP. Some of these limitations are:

- although depreciation and amortization are non-cash charges, the assets being depreciated and amortized might have to be replaced in the future, and adjusted EBITDA does not reflect cash capital expenditure requirements for such replacements or for new capital expenditure requirements;

- adjusted EBITDA does not reflect changes in, or cash requirements for, our working capital needs;
- adjusted EBITDA does not reflect the potentially dilutive impact of stock-based compensation;
- adjusted EBITDA does not reflect interest or tax payments that would reduce the cash available to us; and
- other companies, including companies in our industry, might calculate adjusted EBITDA or a similarly titled measure differently, which reduces their usefulness as comparative measures.

18

Because of these and other limitations, you should consider adjusted EBITDA alongside other GAAP-based financial performance measures, including various cash flow metrics, gross profit, net loss and our other GAAP financial results. The following table presents for each of the periods indicated a reconciliation of adjusted EBITDA to the most directly comparable GAAP financial measure, net loss (in thousands):

	Three Months Ended March 31,	
	2018	2017
Reconciliation from Net Loss to Adjusted EBITDA:		
Net loss	$(13,802)	$(15,583)
Depreciation	2,977	3,110
Amortization of software development costs	889	831
Amortization of acquired intangible assets	64	64
Interest income	(58)	(27)
Interest expense on building lease financing obligations	1,866	1,860
Interest expense on other borrowings	1,317	1,062
Income tax expense	4	-
Stock-based compensation expense	4,325	4,388
Costs not core to our business	1,371	-
Total net adjustments	12,755	11,288
Adjusted EBITDA	$(1,047)	$(4,295)

Components of Operating Results

Revenue

We derive the majority of our revenue from software services fees, which consist primarily of monthly subscription fees paid to us by our employer and carrier customers for access to, and usage of, our cloud-based benefits software solutions for a specified contract term. We also derive revenue from professional services fees, which primarily include fees related to the implementation of our customers onto our platform. Our professional services typically include discovery, configuration and deployment, integration, testing, support and training.

The following table sets forth a breakdown of our revenue between software services and professional services for the periods indicated (in thousands):

	Three Months Ended March 31,	
	2018	2017
Software services	$48,170	$46,501
Professional services	14,193	11,122
Total revenue	$62,363	$57,623

Revenues are recognized when control of these services is transferred to customers, in an amount that reflects the consideration we expect to be entitled to in exchange for those services. Taxes collected from customers relating to services and remitted to governmental authorities are excluded from revenues.

We determine revenue recognition through the following steps:

•Identification of the contract, or contracts, with a customer;

•Identification of the performance obligations in the contract;

•Determination of the transaction price;

•Allocation of the transaction price to the performance obligations in the contract; and

•Recognition of revenue when, or as, performance obligations are satisfied.

Software Services Revenues

Software services revenues primarily consist of monthly subscription fees paid to us by our employer and insurance carrier customers for access to, and usage of, cloud-based benefits software solutions for a specified contract term. Fees are generally charged based on the number of employees or subscribers with access to the solution. Software services revenue also includes insurance broker commissions from the sale of voluntary and ancillary benefits policies to employees of our customers.

Software services revenues are generally recognized on a ratable basis over the contract term beginning on the date the software services are made available to the customer. Our software service contracts are generally three years for both carrier and employer customers. Revenue from insurance broker commissions is recognized when the orders for the policies are received and transferred to the insurance carrier.

Professional Services Revenues

Professional services revenues primarily consist of fees related to the implementation of software products purchased by customers. Professional services typically include discovery, configuration and deployment, integration, testing, and training. Fees from consulting services, support services and training are also included in professional services revenue.

Revenue from implementation services with customers in the Carrier segment are generally recognized over the contract term of the associated software services contract, including any extension periods representing a material right.

Revenues from implementation services with customers in the Employer segment are generally recognized as those services are performed.

Revenues from support and training fees are recognized over the service contract period.

Contracts with Multiple Performance Obligations

Certain of our contracts with customers contain multiple performance obligations. For these contracts, the individual performance obligations are accounted for separately if they are distinct. The transaction price is allocated to the separate performance obligations on a relative standalone selling price basis. We determine the standalone selling prices based on its overall pricing objectives, taking into consideration market conditions and other factors, including the value of its contracts, the software services sold, customer size and complexity, and the number and types of users within the contracts.

Reclassifications

In conjunction with the adoption of the new revenue recognition accounting standard, we reclassified revenue and associated cost of revenue from support and video services from software services to professional services. This reclassification is reflected in all periods presented.

Overhead Allocation

Expenses associated with our facilities, security, information technology, and depreciation and amortization, are allocated between cost of revenue and operating expenses based on employee headcount determined by the nature of work performed.

Cost of Revenue

Cost of revenue primarily consists of salaries and other personnel-related costs, including benefits, bonuses, and stock-based compensation, for employees, whom we refer to as associates, providing services to our customers and supporting our SaaS platform infrastructure. Additional expenses in cost of revenue include co-location facility costs for our data centers, depreciation expense for computer equipment directly associated with generating revenue, infrastructure maintenance costs, professional fees, amortization expenses associated with capitalized software development costs, allocated overhead, and other direct costs.

We expense cost of revenue associated with fulfilling performance obligations as we incur the costs. Costs that relate directly to a customer contract that are not related to satisfying a performance obligation are capitalized and amortized to cost of revenue expense over the estimate period of benefit of the contract asset, which is generally five years.

We plan to continue to expand our capacity to support our growth, which will result in higher cost of revenue in absolute dollars. However, we expect cost of revenue as a percentage of revenue to decline and gross margins to increase primarily from the growth of the percentage of our revenue from large employers and the realization of economies of scale driven by retention of our customer base.

Operating Expenses

Operating expenses consist of sales and marketing, research and development, and general and administrative expenses. Salaries and personnel-related costs are the most significant component of each of these expense categories. We expect to continue to hire new associates in these areas in order to support our anticipated revenue growth; however, we expect to decrease our operating expenses, as a percentage of revenue, as we achieve economies of scale.

Sales and marketing expense. Sales and marketing expense consists primarily of salaries and other personnel-related costs, including benefits, bonuses, stock-based compensation, and commissions for our sales and marketing associates. Costs to obtain a contract that are incremental, such as sales commissions, are capitalized and amortized to expense over the estimated period of benefit of the asset, which is generally four to five years. Additional expenses include advertising, lead generation, promotional event programs, corporate communications, travel, and allocated overhead. For instance, our most significant promotional event is One

Place, which we have held annually. We expect our sales and marketing expense to increase, in absolute dollars, in the foreseeable future as we further increase the number of our sales and marketing professionals and expand our marketing activities in order to continue to grow our business.

Research and development expense. Research and development expense consists primarily of salaries and other personnel-related costs, including benefits, bonuses, and stock-based compensation for our research and development associates. Additional expenses include costs related to the development, quality assurance, and testing of new technology, and enhancement of our existing platform technology, consulting, travel, and allocated overhead. We believe continuing to invest in research and development efforts is essential to maintaining our competitive position. We expect our research and development expense to decrease, as a percentage of revenue, as we achieve economies of scale.

General and administrative expense. General and administrative expense consists primarily of salaries and other personnel-related costs, including benefits, bonuses, and stock-based compensation for administrative, finance and accounting, information systems, legal, and human resource associates. Additional expenses include consulting and professional fees, insurance and other corporate expenses, and travel. We expect our general and administrative expenses to increase in absolute terms as a result of ongoing public company costs, including those associated with compliance with the Sarbanes-Oxley Act and other regulations governing public companies, increased costs of directors' and officers' liability insurance, and increased professional services expenses, particularly associated with the new revenue recognition standard.

Other Income and Expense

Other income and expense consists primarily of interest income and expense and gain (loss) on disposal of property and equipment. Interest income represents interest received on our cash and cash equivalents and marketable securities. Interest expense consists primarily of the interest incurred on outstanding borrowings under our financing obligations, capital leases and credit facility.

Income Tax Expense

Income tax expense consists of U.S. federal and state income taxes. We incurred minimal income tax expense for the three months ended March 31, 2018 and 2017.

Results of Operations

Consolidated Statements of Operations Data

The following table sets forth our consolidated statements of operations data for each of the periods indicated (in thousands):

	Three Months Ended March 31,	
	2018	2017
Revenue	$62,363	$57,623
Cost of revenue[1]	31,403	32,202
Gross profit	30,960	25,421
Operating expenses:		
Sales and marketing[1]	19,917	18,023
Research and development[1]	12,023	12,181

General and administrative[1]	9,693	7,757
Total operating expenses	41,633	37,961
Loss from operations	(10,673)	(12,540)
Other expense:		
Interest income	58	27
Interest expense on building lease financing obligations	(1,866)	(1,860)
Interest expense on other borrowings	(1,317)	(1,062)
Other expense	–	(148)
Total other expense, net	(3,125)	(3,043)
Loss before income taxes	(13,798)	(15,583)
Income tax expense	4	–
Net loss	$(13,802)	$(15,583)

21

(1) Cost of revenue and operating expenses include stock-based compensation expense as follows (in thousands):

	Three Months Ended March 31,	
	2018	2017
Cost of revenue	$711	$661
Sales and marketing	954	1,332
Research and development	768	719
General and administrative	1,892	1,676

The following table sets forth our consolidated statements of operations data as a percentage of revenue for each of the periods indicated (as a percentage of revenue):

	Three Months Ended March 31,	
	2018	2017
Revenue	100.0 %	100.0 %
Cost of revenue	50.4	55.9
Gross profit	49.6	44.1
Operating expenses:		
Sales and marketing	31.9	31.3
Research and development	19.3	21.1
General and administrative	15.5	13.5
Total operating expenses	66.8	65.9
Loss from operations	(17.1)	(21.8)
Other expense:		
Interest income	0.1	-
Interest expense on building lease financing obligations	(3.0)	(3.2)
Interest expense on other borrowings	(2.1)	(1.8)
Other expense	-	(0.3)
Total other expense, net	(5.0)	(5.3)
Loss before income taxes	(22.1)	(27.0)
Income tax expense	-	-
Net loss	(22.1)%	(27.0)%

Our Segments

The following table sets forth segment results for revenue and gross profit for the periods indicated (in thousands):

	Three Months Ended March 31,	
	2018	2017
Revenue from external customers by segment:		
Employer	$40,284	$35,837

Carrier	22,079	21,786
Total net revenue from external customers	$62,363	$57,623
Gross profit by segment:		
Employer	$17,618	$11,943
Carrier	13,342	13,478
Total gross profit	$30,960	$25,421

Comparison of Three Months Ended March 31, 2018 and 2017

Revenue

	Three Months Ended March 31, 2018		2017		Period-to-Period Change	
	Amount	Percentage of Revenue	Amount	Percentage of Revenue	Amount	Percentage
	(in thousands)					
Software services	$48,170	77.2 %	$46,501	80.7 %	$1,669	3.6 %
Professional services	14,193	22.8	11,122	19.3	3,071	27.6
Total revenue	$62,363	100.0 %	$57,623	100.0 %	$4,740	8.2 %

Growth in software services revenue in absolute terms was primarily attributable to an increase in new insurance broker commissions from enrollments in the first quarter partially offset by the impact of revenue from our ACA Reporting product that was recognized in the first quarter of 2017 when the services were completed, but recognized ratably in the same period in 2018 as a result of changes in service delivery.

The increase in professional services revenue was attributable to customer-specific consulting and enhancements, an increase support revenue from newly activated customers and a decrease in the sales returns allowance partially offset by decreases in carrier implementation revenue.

Segment Revenue

	Three Months Ended March 31, 2018		2017		Period-to-Period Change	
	Amount	Percentage of Revenue	Amount	Percentage of Revenue	Amount	Percentage
	(in thousands)					
Employer	$40,284	64.6 %	$35,837	62.2 %	$4,447	12.4 %
Carrier	22,079	35.4	21,786	37.8	293	1.3
Total revenue	$62,363	100.0 %	$57,623	100.0 %	$4,740	8.2 %

Growth in our employer revenue was primarily attributable to a $1.3 million increase in our employer software services revenue, driven by an increase in new insurance broker commissions from enrollments in the first quarter. Additionally, employer professional service revenue increased $3.2 million primarily from increases in implementation and support revenue and a decrease in the sales returns allowance.

The increase in carrier revenue in absolute terms was primarily attributable to volume increases in software services. In carrier professional services, increases in customer-specific consulting and enhancements were offset by a decrease in implementation revenue.

Cost of Revenue

	Three Months Ended March 31, 2018		2017		Period-to-Period Change	
	Amount	Percentage of Revenue	Amount	Percentage of Revenue	Amount	Percentage
	(in thousands)					
Cost of revenue	$31,403	50.4 %	$32,202	55.9 %	$ (799)	(2.5)%

Cost of revenue decreased primarily because of increased salaries, and other personnel-related costs, which were more than offset by lower third party costs and other costs of revenue. Cost of revenue also decreased as a percentage of revenue as we continue to achieve economies of scale.

Gross Profit

Three Months Ended March 31,					
2018		2017		Period-to-Period Change	
Amount	Percentage of Revenue	Amount	Percentage of Revenue	Amount	Percentage
(in thousands)					&nb