Paylocity Holding Corp
Form 10-Q
February 09, 2018
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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, 2017

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.)

3850 N. Wilke Road

Arlington Heights, Illinois	60004
(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 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, 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	(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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date: 52,603,746 shares of Common Stock, $0.001 par value per share, as of February 2, 2018.

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Paylocity Holding Corporation

Form 10-Q

For the Quarterly Period Ended December 31, 2017

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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, 2017	December 31, 2017
Assets		
Current assets:		
Cash and cash equivalents	$ 103,468	$ 111,027
Accounts receivable, net	2,040	2,739
Prepaid expenses and other	14,879	7,456
Total current assets before funds held for clients	120,387	121,222
Funds held for clients	942,459	1,345,702
Total current assets	1,062,846	1,466,924
Long-term prepaid expenses	1,535	1,072
Capitalized internal-use software, net	17,394	18,786
Property and equipment, net	40,756	48,354
Intangible assets, net	8,907	8,189
Goodwill	6,003	6,003
Total assets	$ 1,137,441	$ 1,549,328
Liabilities and Stockholders' Equity		
Current liabilities:		
Accounts payable	$ 2,046	$ 1,794
Accrued expenses	30,301	29,128
Total current liabilities before client fund obligations	32,347	30,922
Client fund obligations	942,459	1,345,702

Total current liabilities	974,806	1,376,624
Deferred rent	14,621	14,243
Deferred income tax liabilities, net	401	308
Total liabilities	$ 989,828	$ 1,391,175
Stockholders' equity:		
Preferred stock, $0.001 par value, 5,000 authorized, no shares issued and outstanding at June 30, 2017 and December 31, 2017	$ —	$ —
Common stock, $0.001 par value, 155,000 shares authorized at June 30, 2017 and December 31, 2017; 51,738 shares issued and outstanding at June 30, 2017 and 52,590 shares issued and outstanding at December 31, 2017	52	53
Additional paid-in capital	192,837	202,512
Accumulated deficit	(45,276)	(44,302)
Accumulated other comprehensive loss	—	(110)
Total stockholders' equity	$ 147,613	$ 158,153
Total liabilities and stockholders' equity	$ 1,137,441	$ 1,549,328

See accompanying notes to unaudited consolidated financial statements.

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PAYLOCITY HOLDING CORPORATION

Unaudited Consolidated Statements of Operations and Comprehensive Income (Loss)

(in thousands, except per share data)

	Three Months Ended December 31,		Six Months Ended December 31,	
	2016	2017	2016	2017
Revenues:				
Recurring fees	$ 65,347	$ 81,292	$ 127,267	$ 158,586
Interest income on funds held for clients	731	1,783	1,448	3,400
Total recurring revenues	66,078	83,075	128,715	161,986
Implementation services and other	2,576	2,929	4,961	5,518
Total revenues	68,654	86,004	133,676	167,504
Cost of revenues:				
Recurring revenues	20,716	25,638	39,819	49,729
Implementation services and other	9,667	11,202	18,923	22,070
Total cost of revenues	30,383	36,840	58,742	71,799
Gross profit	38,271	49,164	74,934	95,705
Operating expenses:				
Sales and marketing	17,735	21,598	35,746	42,778
Research and development	7,222	9,274	14,523	18,169
General and administrative	14,957	18,159	28,815	34,110
Total operating expenses	39,914	49,031	79,084	95,057
Operating income (loss)	(1,643)	133	(4,150)	648
Other income	4	141	43	250
Income (loss) before income taxes	(1,639)	274	(4,107)	898
Income tax expense (benefit)	32	(157)	132	(76)
Net income (loss)	$ (1,671)	$ 431	$ (4,239)	$ 974
Other comprehensive loss, net of tax				
Unrealized losses on securities, net of tax	—	(105)	—	(110)
Total other comprehensive loss, net of tax	—	(105)	—	(110)
Comprehensive income (loss)	$ (1,671)	$ 326	$ (4,239)	$ 864

Net income (loss) per share:

Basic	$ (0.03)	$ 0.01	$ (0.08)	$ 0.02
Diluted	$ (0.03)	$ 0.01	$ (0.08)	$ 0.02
Weighted-average shares used in computing net income (loss) per share:				
Basic	51,384	52,502	51,308	52,197
Diluted	51,384	54,818	51,308	54,639

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	Accumulated	Accumulated Other Comprehensive	Total Stockholders'
	Shares	Amount	Capital	Deficit	Loss	Equity
Balances at June 30, 2017	51,738	$ 52	$ 192,837	$ (45,276)	$ —	$ 147,613
Stock-based compensation	—	—	15,328	—	—	15,328
Stock options exercised	669	1	5,739	—	—	5,740
Issuance of common stock upon vesting of restricted stock units	414	—	—	—	—	—
Issuance of common stock under employee stock purchase plan	53	—	2,045	—	—	2,045
Net settlement for taxes and/or exercise price related to equity awards	(284)	—	(13,437)	—	—	(13,437)
Unrealized losses on securities, net of tax	—	—	—	—	(110)	(110)
Net income	—	—	—	974	—	974
Balances at December 31, 2017	52,590	$ 53	$ 202,512	$ (44,302)	$ (110)	$ 158,153

See accompanying notes to the unaudited consolidated financial statements.

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PAYLOCITY HOLDING CORPORATION

Unaudited Consolidated Statements of Cash Flows

(in thousands)

	Six Months Ended December 31,	
	2016	2017
Cash flows from operating activities:		
Net income (loss)	$ (4,239)	$ 974
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Stock-based compensation expense	12,448	14,424
Depreciation and amortization expense	9,103	13,438
Deferred income tax expense (benefit)	102	(93)
Provision for doubtful accounts	60	76
Net accretion of discounts and amortization of premiums on available-for-sale securities	—	(141)
Net realized losses on sales of available-for-sale securities	—	2
Loss on disposal of equipment	97	106
Changes in operating assets and liabilities:		
Accounts receivable	(446)	(775)
Prepaid expenses and other	845	1,583
Accounts payable	46	(88)
Accrued expenses	(2,626)	(1,290)
Tenant improvement allowance	—	5,952
Net cash provided by operating activities	15,390	34,168
Cash flows from investing activities:		
Purchases of available-for-sale securities from funds held for clients	—	(95,207)
Proceeds from sales and maturities of available-for-sale securities from funds held for clients	—	23,181
Net change in funds held for clients' cash and cash equivalents	147,151	(331,078)
Capitalized internal-use software costs	(6,279)	(7,146)
Purchases of property and equipment	(10,038)	(7,998)
Lease allowances used for tenant improvements	—	(5,952)
Net cash provided by (used in) investing activities	130,834	(424,200)
Cash flows from financing activities:		
Net change in client fund obligations	(147,151)	403,243
Proceeds from employee stock purchase plan	1,823	2,045

Taxes paid related to net share settlement of equity awards	(5,135)	(7,697)
Net cash provided by (used in) financing activities	(150,463)	397,591
Net Change in Cash and Cash Equivalents	(4,239)	7,559
Cash and Cash Equivalents—Beginning of Period	86,496	103,468
Cash and Cash Equivalents—End of Period	$ 82,257	$ 111,027
Supplemental Disclosure of Non-Cash Investing and Financing Activities		
Purchase of property and equipment and internal-use software, accrued but not paid	$ 2,172	$ 482
Supplemental Disclosure of Cash Flow Information		
Cash paid for income taxes, net of refunds	$ 26	$ 60

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"), through its wholly owned subsidiary, Paylocity Corporation, 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 subsidiary. 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. Significant items subject to such estimates and assumptions include the allowance for doubtful accounts, internal-use software, valuation and useful lives of long-lived assets, definite-lived intangibles, goodwill, incurred but not reported medical and dental claims, stock-based compensation, valuation of deferred income tax assets and liabilities and the best estimate of selling price for revenue recognition purposes. 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.

(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, 2017 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, 2017 included in the Company's Annual Report on Form 10-K filed with the SEC on August 11, 2017.

(c) Funds Held For Clients and Corporate Investments

Funds held for clients is primarily comprised of cash and cash equivalents invested in demand deposit accounts. Starting in July 2017, the Company also invested a portion of its funds held for clients in marketable securities.

Marketable securities classified as available-for-sale are recorded at fair value on the consolidated balance sheets. Unrealized gains and losses, net of applicable income taxes, are reported as other comprehensive income (loss) in the consolidated statements of operations and comprehensive income (loss). Interest on marketable securities included in

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funds held for clients is reported as interest income on funds held for clients on the consolidated statements of operations and comprehensive income (loss).

The Company reviews the composition of its portfolio for any available-for-sale security that has a fair value that falls below its amortized cost. If any security fits this criterion, the Company further evaluates whether other-than-temporary impairment exists by considering whether the Company has the intent and ability to retain the security for a period of time sufficient enough to allow for anticipated fair value recovery. The Company did not record any other-than-temporary impairment charges during the three or six months ended December 31, 2017.

(d) Income Taxes

Income taxes are accounted for in accordance with ASC 740, Income Taxes, using the asset and liability 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) Stock-Based Compensation

The Company recognizes all employee stock-based compensation as a cost in the financial statements. Equity-classified awards, including those under the 2014 Employee Stock Purchase Plan (“ESPP”), are measured at the grant date fair value of the award and expense is recognized, net of assumed forfeitures, on a straight-line basis over the requisite service period for each separately vesting portion of the award. The Company estimates grant date fair value using the Black-Scholes option-pricing model and periodically updates the assumed forfeiture rates for actual experience over the option vesting term or the term of the ESPP purchase period.

(f) Recently Issued Accounting Standards

In May 2014, the Financial Accounting Standards Board (FASB) issued ASU 2014-09, Revenue from Contracts with Customers (Topic 606) ("ASU 2014-09"). ASU 2014-09 supersedes a majority of existing revenue recognition guidance under US 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. Companies may need to apply more judgment and estimation techniques or methods while recognizing revenue, which could result in additional disclosures to the financial statements. In addition, in March 2016, April 2016, May 2016 and December 2016 the FASB issued ASU 2016-08, Revenue from Contracts with Customers (Topic 606): Principal versus Agent Considerations (Reporting Revenue Gross versus Net) ("ASU 2016-08"), ASU 2016-10, Revenue from Contracts with Customers (Topic 606): Identifying Performance Obligations and Licensing ("ASU 2016-10"), ASU 2016-12, Revenue from Contracts with Customers (Topic 606): Narrow-Scope Improvements and Practical Expedients ("ASU 2016-12") and ASU 2016-20, Technical Corrections and Improvements to Topic 606, Revenue from Contracts with Customers ("ASU 2016-20"), respectively, to amend certain guidance in ASU 2014-09. Topic 606 allows for either a retrospective or cumulative effect transition method. ASU 2014-09 was originally effective for fiscal years beginning after December 15, 2016. In July 2015, the FASB approved a one-year deferral of ASU 2014-09 and all amendments to it, with a new effective date for fiscal years beginning after December 15, 2017 with early adoption permitted as of the original effective date.

The Company currently expects to adopt the new standard in its fiscal year beginning July 1, 2018 using the full retrospective method. While the impact the new revenue recognition standard will have on its consolidated financial statements and disclosures has not yet been fully assessed, the Company currently expects that there will be a material impact in the manner in which it treats certain costs of obtaining new contracts (i.e., selling and commission costs). The

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new standard will require the Company to defer these costs and amortize them versus current treatment of expensing these costs as incurred. The Company is continuing to evaluate all potential impacts as well as the changes required for systems, processes and internal controls to meet the new standard's reporting and disclosure requirements.

In February 2016, the FASB issued ASU 2016-02, Leases (Topic 842) ("ASU 2016-02") which amends various aspects of existing guidance for leases. ASU 2016-02 requires an entity to recognize assets and liabilities arising from a lease with terms greater than twelve months, along with additional qualitative and quantitative disclosures. ASU 2016-02 also requires the use of the modified retrospective method, which will require adjustment to all comparative periods presented. ASU 2016-02 is effective for fiscal years beginning after December 15, 2018, with early adoption permitted. The Company is currently assessing the potential effects of these changes to its consolidated financial statements and expects to adopt this new standard in its fiscal year beginning July 1, 2019.

In March 2016, the FASB issued ASU 2016-09, Compensation – Stock Compensation (Topic 718) ("ASU 2016-09") which modifies accounting for excess tax benefits and tax deficiencies, forfeitures, and employer tax withholding requirements. ASU 2016-09 also clarifies certain classifications on the statement of cash flows. ASU 2016-09 is effective for fiscal years beginning after December 15, 2016, with early adoption permitted. The Company adopted this standard effective July 1, 2017. Due to the Company's tax valuation allowance, the adoption of this standard did not have a material impact on its consolidated financial statements and disclosures. The Company will continue to estimate forfeitures at each reporting period, rather than electing an accounting policy change to record the impact of such forfeitures as they occur.

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, 2017	$ 266
Charged to expense	76

Write-offs	(85)
Balance at December 31, 2017	$ 257

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

	June 30, 2017	December 31, 2017
Capitalized internal-use software	$ 49,663	$ 57,758
Accumulated amortization	(32,269)	(38,972)
Capitalized internal-use software, net	$ 17,394	$ 18,786

Amortization of capitalized internal-use software costs is included in Cost of Revenues-Recurring Revenues and amounted to $1,950 and $3,314 for the three months ended December 31, 2016 and 2017, respectively, and $3,634 and $6,703 for the six months ended December 31, 2016 and 2017, respectively.

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Property and equipment, net consist of the following:

	June 30, 2017	December 31, 2017
Office equipment	$ 3,591	$ 3,797
Computer equipment	24,411	27,567
Furniture and fixtures	7,547	8,821
Software	4,954	5,008
Leasehold improvements	21,426	29,324
Time clocks rented by clients	4,240	4,489
Total	66,169	79,006
Accumulated depreciation	(25,413)	(30,652)
Property and equipment, net	$ 40,756	$ 48,354

Depreciation expense amounted to $2,504 and $3,092 for the three months ended December 31, 2016 and 2017, respectively, and $4,707 and $6,017 for the six months ended December 31, 2016 and 2017, respectively.

Intangible assets, net consist of the following:

	June 30, 2017	December 31, 2017	Weighted Average Useful Life
Client relationships	$ 12,580	$ 12,580	9 years
Non-solicitation agreements	360	360	2 - 3 years
Total	12,940	12,940	
Accumulated amortization	(4,033)	(4,751)	
Intangible assets, net	$ 8,907	$ 8,189	

Amortization expense for acquired intangible assets was $381 and $359 for the three months ended December 31, 2016 and 2017, respectively, and $762 and $718 for the six months ended December 31, 2016 and 2017, respectively.

Future amortization expense for acquired intangible assets is as follows, as of December 31, 2017:

Remainder of fiscal 2018	$ 709
Fiscal 2019	1,398
Fiscal 2020	1,398
Fiscal 2021	1,398
Fiscal 2022	1,398
Thereafter	1,888
Total	$ 8,189

The components of accrued expenses were as follows:

	June 30, 2017	December 31, 2017
Accrued payroll and personnel costs	$ 25,131	$ 22,405
Other	5,170	6,723
Total accrued expenses	$ 30,301	$ 29,128

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(4) Funds Held for Clients and Corporate Investments

Investments consist of the following as of December 31, 2017:

Type of Issue	Amortized cost	Gross unrealized gains	Gross unrealized losses	Fair value
Funds held for clients' cash and cash equivalents	$ 1,273,819	$ —	$ (5)	$ 1,273,814
Available-for-sale securities:				
Corporate bonds	34,323	5	(70)	34,258
Commercial paper	25,375	—	(13)	25,362
Asset-backed securities	12,295	—	(27)	12,268
Total available-for-sale securities	71,993	5	(110)	71,888
Investments	$ 1,345,812	$ 5	$ (115)	$ 1,345,702

Investments are classified as Funds held for clients on the consolidated balance sheets. Funds held for clients’ cash and cash equivalents included demand deposit accounts, commercial paper and money market funds as of December 31, 2017.

Available-for-sale securities that have been in an unrealized loss position for a period of less than 12 months as of December 31, 2017 had fair market values as follows:

	Gross unrealized losses	Fair value
Corporate bonds	$ (70)	$ 31,549
Commercial paper	(13)	25,362
Asset-backed securities	(27)	12,268
Total	$ (110)	$ 69,179

As the Company started investing funds held for clients in available-for-sale securities during the six months ended December 31, 2017, no securities have been in an unrealized loss position for more than 12 months. 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. 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.

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, nor does it believe that OTTI exists in its portfolio as of December 31, 2017. 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, 2017.

Expected maturities of available-for-sale securities at December 31, 2017 are as follows:

	Amortized cost	Fair value
One year or less	$ 54,968	$ 54,912
One year to two years	15,421	15,368
Two years to three years	1,604	1,608
Total available-for-sale securities	$ 71,993	$ 71,888

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(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.

The Company measures any 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, 2017 and December 31, 2017 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 asset-backed securities, corporate bonds and commercial paper. 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 December 31, 2017, and the Company did not transfer assets between Levels during the six months ended December 31, 2017. The Company did not hold any marketable securities at June 30, 2017.

The fair value level for the funds held for clients' cash and cash equivalents and available-for-sale securities as of December 31, 2017 is as follows:

	Total	Level 1	Level 2	Level 3
Funds held for clients' cash and cash equivalents	$ 1,273,814	$ 1,245,955	$ 27,859	$ —
Available-for-sale securities:				
Corporate bonds	34,258		34,258	
Commercial paper	25,362		25,362	
Asset-backed securities	12,268		12,268	
Total available-for-sale securities	71,888	—	71,888	—
Investments	$ 1,345,702	$ 1,245,955	$ 99,747	$ —

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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, 2017, the Company had 11,589 shares allocated to the plans, of which 3,940 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, 2017:

	Number of Shares
Available for grant at July 1, 2017	8,227
RSUs granted	(845)
Shares withheld in settlement of taxes and/or exercise price	284
Forfeitures	28
Shares removed	(45)
Available for grant at December 31, 2017	7,649

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 (loss):

	Three Months Ended December 31,		Six Months Ended December 31,	
	2016	2017	2016	2017
Cost of revenue – recurring	$ 593	$ 734	$ 1,136	$ 1,356
Cost of revenue – non-recurring	367	377	668	749
Sales and marketing	1,683	2,205	3,208	4,143
Research and development	870	945	1,664	1,816
General and administrative	3,122	3,557	5,772	6,360
Total stock-based compensation expense	$ 6,635	$ 7,818	$ 12,448	$ 14,424

In addition, the Company capitalized $500 and $471 of stock-based compensation expense in its capitalized internal-use software costs in the three months ended December 31, 2016 and 2017, respectively, and $872 and $904 in the six months ended December 31, 2016 and 2017, 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, 2016 or 2017. The table below presents stock option activity during the six months ended December 31, 2017:

	Outstanding Options			
	Number of shares	Weighted average exercise price	Weighted average remaining contractual term (years)	Aggregate intrinsic value
Balance at July 1, 2017	2,751	$ 11.54	5.69	$ 92,556
Options forfeited	(4)	$ 17.00		
Options exercised	(669)	$ 8.58		
Balance at December 31, 2017	2,078	$ 12.48	5.52	$ 72,068
Options exercisable at December 31, 2017	1,951	$ 11.36	5.42	$ 69,856
Options vested and expected to vest at December 31, 2017	2,072	$ 12.43	5.52	$ 71,981

The total intrinsic value of options exercised was $1,648 and $23,875 during the three months ended December 31, 2016 and 2017, respectively, and $5,539 and $27,255 during the six months ended December 31, 2016 and 2017, respectively. At December 31, 2017, there was $365 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 1.06 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 RSU awards are based on the achievement of certain revenue and Adjusted EBITDA targets in future fiscal years. The following table represents restricted stock unit activity during the six months ended December 31, 2017:

	Units	Weighted average grant date fair value
RSU balance at July 1, 2017	1,455	$ 39.96
RSUs granted	845	$ 45.72

RSUs vested	(414)	$ 39.37
RSUs forfeited	(24)	$ 41.41
RSU balance at December 31, 2017	1,862	$ 42.68
RSUs expected to vest at December 31, 2017	1,605	$ 42.48

At December 31, 2017, there was $40,457 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 1.94 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, 2017, a total of 771 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 53 shares upon the completion of its six-month offering period ending November 15, 2017. The Company recorded compensation expense attributable to the ESPP of $319 and $309 for the three months ended December 31, 2016 and 2017, respectively, and $663 and $648 for the six months ended December 31, 2016 and 2017, 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,	
	2016	2017
Valuation assumptions:		
Expected dividend yield	0 %	0 %
Expected volatility	38.9 - 53.4 %	28.3 - 39.1 %
Expected term (years)	0.5	0.5
Risk free interest rate	0.28 - 0.61 %	1.02 - 1.35 %

(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 $775 and $995 for the three months ended December 31, 2016 and 2017, respectively, and $1,677 and $2,106 for the six months ended December 31, 2016 and 2017, respectively.

(7) Net Income (Loss) Per Share

Basic net income (loss) per common share is computed using the weighted average number of common shares outstanding during the period. Diluted net income (loss) 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 (loss) per share:

	Three Months Ended December 31,		Six Months Ended December 31,	
	2016	2017	2016	2017
Numerator:				
Net income (loss)	$ (1,671)	$ 431	$ (4,239)	$ 974
Denominator:				
Weighted-average shares used in computing net income (loss) per share:				
Basic	51,384	52,502	51,308	52,197
Weighted-average effect of potentially dilutive shares:				
Employee stock options and restricted stock units	—	2,316	—	2,442
Diluted	51,384	54,818	51,308	54,639
Net income (loss) per share:				
Basic	$ (0.03)	$ 0.01	$ (0.08)	$ 0.02
Diluted	$ (0.03)	$ 0.01	$ (0.08)	$ 0.02

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The following table summarizes the outstanding employee stock options, restricted stock units, and shares purchasable via the employee stock purchase plan 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,	
	2016	2017	2016	2017
Employee stock options	3,262	—	3,262	—
Restricted stock units	1,501	5	1,501	795
Employee stock purchase plan shares	21	15	21	15
Total	4,784	20	4,784	810

(8) Income Taxes

The Company's quarterly provision for income taxes is based on the discrete effective tax 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, in the interim period in which they occur.

The Company recorded income tax expense (benefit) of $32 and $(157) for the three months ended December 31, 2016 and 2017 respectively, and $132 and $(76) for the six months ended December 31, 2016 and 2017, respectively. The Company's effective tax rates for the three and six months ended December 31, 2016 and 2017 differ from statutory rates primarily due to the existence of a valuation allowance recorded against the preponderance of the net deferred tax assets.

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. It established a valuation allowance on all of its net deferred tax assets except for deferred tax liabilities associated with indefinite-lived intangible assets during fiscal 2014, 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 has continued to carry the valuation allowance during fiscal 2017 and for the six months ended December 31, 2017. However, it is reasonably possible within this fiscal year that the Company may release all or a portion of its valuation allowance if results and other subjective evidence continue to improve such that the deferred tax assets become more likely than not to be realizable. As of December 31, 2017, the Company had no unrecognized tax benefits.

On December 22, 2017, the Tax Cuts and Jobs Act of 2017 (the Act) was signed into law. Over the long term, the Company generally expects to benefit from the lower statutory rates provided by the Act and is currently assessing all other aspects relevant to the Company. 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 the Company modified its current federal statutory rate for the year to account for the rate change. The Company recorded a $156 income tax benefit attributable to the rate change effect on the deferred tax liability for indefinite-lived intangible assets.

In response to the Act, the SEC issued SAB 118 allowing registrants to record provisional amounts to the extent a company's accounting for the Act is incomplete. Pursuant to disclosure under SAB 118, revaluation of deferred taxes as of December 22, 2017 is incomplete. Items recorded as provisional amounts include a revaluation of deferred tax assets as of June 30, 2017. The provisional amount computed was $3,404 of income tax expense. As the Company maintains a valuation allowance against all of its deferred taxes except for a deferred tax liability related to indefinite-lived intangible assets, this expense was offset by the valuation allowance. As of December 31, 2017, the Company is still analyzing the impact of the Act with respect to the appropriate period of reversal of deferred tax assets and liabilities, as well as additional limitations on the deductibility of executive compensation and on certain meals and entertainment expenses and the related impacts to the assessment of valuation allowance. The Company needs additional time to obtain, prepare, and analyze information related to the above mentioned items before the assessment of the impact of the Act can be completed. The Company expects to complete its accounting for the effects of the Act by the end of fiscal year 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 (or "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 200 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 functionality. 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 medium-sized 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

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private sector employment growth and business productivity, increases in the unemployment rate and changes in interest 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. Our interest income on funds held for clients continues to be adversely impacted by historically low interest rates.

Our operating subsidiary Paylocity Corporation was incorporated in July 1997 as an Illinois corporation. In November 2013, we formed Paylocity Holding Corporation, a Delaware corporation, of which Paylocity Corporation is a wholly-owned subsidiary. Paylocity Holding Corporation had no operations prior to the restructuring. All of 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 Paylocity Corporation, and the financial results presented herein are entirely attributable to the results of its 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 $66.1 million for the three months ended December 31, 2016 to $83.1 million for the three months ended December 31, 2017, representing a 26% year-over-year increase. Recurring revenue increased from $128.7 million for the six months ended December 31, 2016 to $162.0 million for the six months ended December 31, 2017, representing a 26% year-over-year increase. Recurring revenue represented 96% and 97% of total revenue during both the three months and six months ended December 31, 2016 and 2017, respectively.

Recurring Fees from New Clients

We define recurring fees from new clients as the percentage of year-to-date recurring fees from all clients on our solutions which had not been on or used any of our solutions for a full year as of the start of the current fiscal year. We believe recurring fees from new clients is an important metric to measure the expansion of our existing client base as well as the growth in our client base. Our percentage of recurring fees from new clients was 36% and 30% for the

three months ended December 31, 2016 and 2017, respectively, and 34% and 29% for the six months ended December 31, 2016 and 2017, 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 (used in) 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

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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 (loss) before interest expense, income tax expense (benefit), depreciation and amortization expense, 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.

	Three Months Ended December 31,		Six Months Ended December 31,	
	2016	2017	2016	2017
	(in thousands)		(in thousands)	
Adjusted Gross Profit	$ 41,194	$ 53,621	$ 80,494	$ 104,732
Adjusted Recurring Gross Profit	$ 47,912	$ 61,504	$ 93,735	$ 120,450
Adjusted EBITDA	$ 9,870	$ 15,245	$ 17,841	$ 29,837

	Three Months Ended December 31,		Six Months Ended December 31,	
	2016	2017	2016	2017
	(in thousands)		(in thousands)	
Reconciliation from Gross Profit to Adjusted Gross Profit				
Gross profit	$ 38,271	$ 49,164	$ 74,934	$ 95,705
Amortization of capitalized internal-use software costs	1,950	3,314	3,634	6,703
Stock-based compensation expense and employer payroll taxes related to stock releases and option exercises	973	1,143	1,926	2,324
Adjusted Gross Profit	$ 41,194	$ 53,621	$ 80,494	$ 104,732

	Three Months Ended December 31,		Six Months Ended December 31,	
	2016	2017	2016	2017
	(in thousands)		(in thousands)	
Reconciliation from Total Recurring Revenues to Adjusted Recurring Gross Profit				
Total recurring revenues	$ 66,078	$ 83,075	$ 128,715	$ 161,986
Cost of recurring revenues	20,716	25,638	39,819	49,729
Recurring gross profit	45,362	57,437	88,896	112,257
Amortization of capitalized internal-use software costs	1,950	3,314	3,634	6,703
Stock-based compensation expense and employer payroll taxes related to stock releases and option exercises	600	753	1,205	1,490
Adjusted Recurring Gross Profit	$ 47,912	$ 61,504	$ 93,735	$ 120,450

	Three Months Ended December 31,		Six Months Ended December 31,	
	2016	2017	2016	2017
	(in thousands)		(in thousands)	
Reconciliation from Net Income (Loss) to Adjusted EBITDA				
Net income (loss)	$ (1,671)	$ 431	$ (4,239)	$ 974
Income tax expense (benefit)	32	(157)	132	(76)
Depreciation and amortization expense	4,835	6,765	9,103	13,438
EBITDA	3,196	7,039	4,996	14,336
Stock-based compensation expense and employer payroll taxes related to stock releases and option exercises	6,674	8,206	12,845	15,501
Adjusted EBITDA	$ 9,870	$ 15,245	$ 17,841	$ 29,837

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Basis of Presentation

Revenues

Recurring Fees

We derive the majority of our revenues from recurring fees attributable to our cloud-based payroll and HCM software solutions. Recurring fees for each client generally include a base fee in addition to a fee based on the number of client employees and the number of products a client uses. We also charge fees attributable to our preparation of W-2 documents and annual required filings on behalf of our clients. Over the past three years, our client size has been on average over 100 employees. We derive revenue from a client based on the solutions purchased by the client, the number of client employees as well as the amount, type and timing of services provided with respect to those client employees. As such, the number of client employees on our system is not a good indicator of our financial results in any period. Recurring fees attributable to our cloud-based payroll and HCM solutions accounted for 95% of our total revenues during both the three and six months ended December 31, 2016 and 2017.

The majority of our agreements with clients do not have a specified term and are generally cancellable by the client on 60 days' or less notice. Our agreements do not include general rights of return and do not provide clients with the right to take possession of the software supporting the services being provided. We recognize recurring fees in the period in which services are provided and when collection of fees is reasonably assured and the amount of fees is fixed or determinable.

Interest Income on Funds Held for Clients

We earn interest income on funds held for clients. We collect funds for employee payroll payments and related taxes in advance of remittance to employees and taxing authorities. Prior to remittance to employees and taxing authorities, we earn interest on these funds through demand deposit accounts with financial institutions with which we have automated clearing house, or ACH, arrangements. We also earn interest by investing a portion of funds held for clients in highly liquid, investment-grade marketable securities.

Implementation Services and Other

Implementation services and other revenues primarily consist of implementation fees charged to new clients for professional services provided to implement and configure our payroll and HCM solutions. Implementations of our payroll solutions typically require only three to four weeks at which point the new client's payroll is first run using our solution, our implementation services are deemed completed, and we recognize the related revenue. We implement additional HCM products as requested by clients and leverage the data within our payroll solution to accelerate our implementation processes. Implementation services and other revenues may fluctuate significantly from quarter to quarter based on the number of new clients, pricing and the product utilization.

Cost of Revenues

Cost of Recurring Revenues

Cost of recurring revenues is generally expensed as incurred, and includes costs to provide our payroll and other HCM solutions primarily consisting of employee-related expenses, including wages, stock-based compensation, bonuses and benefits, relating to the provision of ongoing client support, payroll tax filing and distribution of printed checks and other materials. These costs also include amortization of capitalized internal-use software costs, delivery costs and computing costs, as well as bank fees associated with client fund transfers. We expect to realize cost efficiencies over the long term as our business scales, resulting in improved operating leverage and increased margins.

We capitalize a portion of our internal-use software costs, which are then all amortized as a cost of recurring revenues. We amortized $2.0 million and $3.3 million of capitalized internal-use software costs during the three months ended December 31, 2016 and 2017, respectively, and $3.6 million and $6.7 million of capitalized internal-use software costs during the six months ended December 31, 2016 and 2017, respectively.

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Cost of Implementation Services and Other

Cost of implementation services and other consists primarily of employee-related expenses, including wages, stock-based compensation, bonuses and benefits involved in the implementation of our payroll and other HCM solutions for new clients. Implementation costs are generally fixed in the short-term and exceed associated implementation revenue charged to each client. We intend to grow our business through acquisition of new clients, and doing so will require increased personnel to implement our solutions. Therefore our cost of implementation services and other is expected to increase in absolute dollars for the foreseeable future.

Operating Expenses

Sales and Marketing

Sales and marketing expenses consist primarily of employee-related expenses for our direct sales and marketing staff, including wages, commissions, stock-based compensation, bonuses and benefits, marketing expenses and other related costs. Commissions are primarily earned and recognized in the month when implementation is complete and the client first utilizes a service and are typically paid within two months after the start of service. Bonuses paid to sales staff for attainment of certain performance criteria are accrued in the fiscal year in which they are earned and are subsequently paid annually in the first fiscal quarter of the following year.

We will seek to grow our number of clients for the foreseeable future, and therefore our sales and marketing expense is expected to continue to increase in absolute dollars as we grow our sales organization and expand our marketing activities.

Research and Development

Research and development expenses consist primarily of employee-related expenses for our research and development and product management staff, including wages, stock-based compensation, bonuses and benefits. Additional expenses include costs related to the development, maintenance, quality assurance and testing of new technologies and ongoing refinement of our existing solutions. Research and development expenses, other than internal-use software costs qualifying for capitalization, are expensed as incurred.

We capitalize a portion of our development costs related to internal-use software. The timing of our capitalized development projects may affect the amount of development costs expensed in any given period. The table below sets forth the amounts of capitalized and expensed research and development expenses for the three and six months ended December 31, 2016 and 2017.

	Three Months Ended December 31,		Six Months Ended December 31,	
	2016	2017	2016	2017
	(in thousands)		(in thousands)	
Capitalized portion of research and development	$ 3,842	$ 4,121	$ 7,151	$ 8,095
Expensed portion of research and development	7,222	9,274	14,523	18,169
Total research and development	$ 11,064	$ 13,395	$ 21,674	$ 26,264

We expect to grow our research and development efforts as we continue to broaden our product offerings and extend our technological leadership by investing in the development of new technologies and introducing them to new and existing clients. We expect research and development expenses to continue to increase in absolute dollars but to vary as a percentage of total revenue on a period-to-period basis.

General and Administrative

General and administrative expenses consist primarily of employee-related costs, including wages, stock-based compensation, bonuses and benefits for our administrative, finance, accounting, and human resources departments. Additional expenses include consulting and professional fees, occupancy costs, insurance and other corporate expenses. We expect our general and administrative expenses to continue to increase in absolute dollars as our company continues to grow.

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Other Income

Other income generally consists of interest income related to interest received on our cash and cash equivalents, net of losses on disposal of property and equipment.

Results of Operations

The following table sets forth our statements of operations data for each of the periods indicated.

	Three Months Ended December 31,		Six Months Ended December 31,	
	2016	2017	2016	2017
	(in thousands)		(in thousands)	
Consolidated Statements of Operations Data:				
Revenues:				
Recurring fees	$ 65,347	$ 81,292	$ 127,267	$ 158,586
Interest income on funds held for clients	731	1,783	1,448	3,400
Total recurring revenues	66,078	83,075	128,715	161,986
Implementation services and other	2,576	2,929	4,961	5,518
Total revenues	68,654	86,004	133,676	167,504
Cost of revenues:				
Recurring revenues	20,716	25,638	39,819	49,729
Implementation services and other	9,667	11,202	18,923	22,070
Total cost of revenues	30,383	36,840	58,742	71,799
Gross profit	38,271	49,164	74,934	95,705
Operating expenses:				
Sales and marketing	17,735	21,598	35,746	42,778
Research and development	7,222	9,274	14,523	18,169
General and administrative	14,957	18,159	28,815	34,110
Total operating expenses	39,914	49,031	79,084	95,057
Operating income (loss)	(1,643)	133	(4,150)	648
Other income	4	141	43	250
Income (loss) before income taxes	(1,639)	274	(4,107)	898
Income tax expense (benefit)	32	(157)	132	(76)
Net income (loss)	$ (1,671)	$ 431	$ (4,239)	$ 974

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The following table sets forth our statements of operations data as a percentage of total revenues for each of the periods indicated.

	Three Months Ended December 31,		Six Months Ended December 31,	
	2016	2017	2016	2017
Consolidated Statements of Operations Data:				
Revenues:				
Recurring fees	95 %	95 %	95 %	95 %
Interest income on funds held for clients	1 %	2 %	1 %	2 %
Total recurring revenues	96 %	97 %	96 %	97 %
Implementation services and other	4 %	3 %	4 %	3 %
Total revenues	100 %	100 %	100 %	100 %
Cost of revenues:				
Recurring revenues	30 %	30 %	30 %	30 %
Implementation services and other	14 %	13 %	14 %	13 %
Total cost of revenues	44 %	43 %	44 %	43 %
Gross profit	56 %	57 %	56 %	57 %
Operating expenses:				
Sales and marketing	26 %	25 %	26 %	25 %
Research and development	10 %	11 %	11 %	11 %
General and administrative	22 %	20 %	22 %	20 %
Total operating expenses	58 %	56 %	59 %	56 %
Operating income (loss)	(2) %	1 %	(3) %	1 %
Other income	0 %	0 %	0 %	0 %
Income (loss) before income taxes	(2) %	1 %	(3) %	1 %
Income tax expense (benefit)	0 %	0 %	0 %	0 %
Net income (loss)	(2) %	1 %	(3) %	1 %

Comparison of Three Months Ended December 31, 2016 and 2017

Revenues

	Three Months Ended December 31,		Change	
	2016	2017	$	%
Recurring fees	$ 65,347	$ 81,292	$ 15,945	24 %
Percentage of total revenues	95 %	95 %		
Interest income on funds held for clients	$ 731	$ 1,783	$ 1,052	144 %

Percentage of total revenues	1	%	2	%			
Implementation services and other	$ 2,576		$ 2,929		$ 353	14	%
Percentage of total revenues	4	%	3	%			

Recurring Fees

Recurring fees for the three months ended December 31, 2017 increased by $15.9 million, or 24%, to $81.3 million from $65.3 million for the three months ended December 31, 2016. Recurring fees increased primarily as a result of incremental revenues from new and existing clients.

Interest Income on Funds Held for Clients

Interest income on funds held for clients for the three months ended December 31, 2017 increased by $1.1 million, or 144% to $1.8 million from $0.7 million for the three months ended December 31, 2016. Interest income on funds held for clients increased primarily as a result of higher average interest rates, increased average daily balances for funds held due to the addition of new clients to our client base and interest income from investing a portion of our funds held for clients in marketable securities starting in July 2017.

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Implementation Services and Other

Implementation services and other revenue for the three months ended December 31, 2017 increased by $0.4 million, or 14%, to $2.9 million from $2.6 million for the three months ended December 31, 2016 primarily due to the changes in the number of new clients and product mix quarter over quarter.

Cost of Revenues

	Three Months Ended December 31,				Change	
	2016		2017		$	%
Cost of recurring revenues	$ 20,716		$ 25,638		$ 4,922	24 %
Percentage of recurring revenues	31	%	31	%		
Recurring gross margin	69	%	69	%		
Cost of implementation services and other	$ 9,667		$ 11,202		$ 1,535	16 %
Percentage of implementation services and other	375	%	382	%		
Implementation gross margin	(275)	%	(282)	%		

Cost of Recurring Revenues

Cost of recurring revenues for the three months ended December 31, 2017 increased by $4.9 million, or 24%, to $25.6 million from $20.7 million for the three months ended December 31, 2016. Cost of recurring revenues increased primarily as a result of the continued growth of our business, in particular, $1.9 million in additional employee-related costs resulting from additional personnel necessary to provide services to new and existing clients, $1.5 million in delivery and other processing-related fees and $1.4 million in increased internal-use software amortization. Recurring gross margin remained consistent at 69% for the three months ended December 31, 2016 and 2017.

Cost of Implementation Services and Other

Cost of implementation services and other for the three months ended December 31, 2017 increased by $1.5 million, or 16%, to $11.2 million from $9.7 million for the three months ended December 31, 2016. The increase in cost of implementation services and other was primarily the result of $1.3 million of additional employee-related costs to implement our solutions for new and existing clients during the three months ended December 31, 2017.

Operating Expenses

Sales and Marketing

	Three Months Ended December 31,		Change	
	2016	2017	$	%
Sales and marketing	$ 17,735	$ 21,598	$ 3,863	22 %
Percentage of total revenues	26 %	25 %		

Sales and marketing expenses for the three months ended December 31, 2017 increased by $3.9 million, or 22%, to $21.6 million from $17.7 million for the three months ended December 31, 2016. The increase in sales and marketing expense was primarily the result of $2.8 million of additional employee-related costs from the expansion of our sales team (including management, sales engineers, direct sales, sales administration and sales lead generation support). The increase was also attributable to $0.5 million in additional stock-based compensation associated with our equity incentive plan.

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Research and Development

	Three Months Ended December 31,		Change	
	2016	2017	$	%
Research and development	$ 7,222	$ 9,274	$ 2,052	28 %
Percentage of total revenues	10 %	11 %		

Research and development expenses for the three months ended December 31, 2017 increased by $2.1 million, or 28%, to $9.3 million from $7.2 million for the three months ended December 31, 2016. The increase in research and development expense was primarily the result of $2.1 million of additional employee-related costs related to additional development personnel.

General and Administrative

	Three Months Ended December 31,		Change	
	2016	2017	$	%
General and administrative	$ 14,957	$ 18,159	$ 3,202	21 %
Percentage of total revenues	22 %	20 %		

General and administrative expenses for the three months ended December 31, 2017 increased by $3.2 million, or 21%, to $18.2 million from $15.0 million for the three months ended December 31, 2016. The increase in general and administrative expense was primarily the result of $1.4 million of additional employee-related costs, $0.9 million of increased occupancy costs incurred as a result of our requirement for additional office space and $0.4 million in additional stock-based compensation associated with our equity incentive plan.

Other Income

	Three Months Ended December 31,		Change	
	2016	2017	$	%
Other income	$ 4	$ 141	$ 137	*

Percentage of total revenues	0	%	0	%

*Not Meaningful

Other income for the three months ended December 31, 2017 was not materially different as compared to the three months ended December 31, 2016.

Income Tax Expense (Benefit)

	Three Months Ended December 31,		Change	
	2016	2017	$	%
Income tax expense (benefit)	$ 32	$ (157)	$ (189)	*
Percentage of total revenues	0 %	0 %		

*Not Meaningful

The difference in income tax expense (benefit) for the three months ended December 31, 2017 as compared to the three months ended December 31, 2016 was primarily due to the revaluation of deferred taxes arising from the Tax Cuts and Jobs Act.

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Comparison of Six Months Ended December 31, 2016 and 2017

Revenues

	Six Months Ended December 31,		Change	
	2016	2017	$	%
Recurring fees	$ 127,267	$ 158,586	$ 31,319	25 %
Percentage of total revenues	95 %	95 %		
Interest income on funds held for clients	$ 1,448	$ 3,400	$ 1,952	135 %
Percentage of total revenues	1 %	2 %		
Implementation services and other	$ 4,961	$ 5,518	$ 557	11 %
Percentage of total revenues	4 %	3 %		

Recurring Fees

Recurring fees for the six months ended December 31, 2017 increased by $31.3 million, or 25%, to $158.6 million from $127.3 million for the six months ended December 31, 2016. Recurring fees increased primarily as a result of incremental revenues from new and existing clients.

Interest Income on Funds Held for Clients

Interest income on funds held for clients for the six months ended December 31, 2017 increased by $2.0 million, or 135% to $3.4 million from $1.4 million for the six months ended December 31, 2016. Interest income on funds held for clients increased primarily as a result of higher average interest rates, increased average daily balances for funds held due to the addition of new clients to our client base and interest income from investing a portion of our funds held for clients in marketable securities starting in July 2017.

Implementation Services and Other

Implementation services and other revenue for the six months ended December 31, 2017 increased by $0.6 million, or 11%, to $5.5 million from $5.0 million for the six months ended December 31, 2016 primarily due to the changes in the number of new clients and product mix period over period.

Cost of Revenues

	Six Months Ended December 31,				Change	
	2016		2017		$	%
Cost of recurring revenues	$ 39,819		$ 49,729		$ 9,910	25 %
Percentage of recurring revenues	31	%	31	%		
Recurring gross margin	69	%	69	%		
Cost of implementation services and other	$ 18,923		$ 22,070		$ 3,147	17 %
Percentage of implementation services and other	381	%	400	%		
Implementation gross margin	(281)	%	(300)	%		

Cost of Recurring Revenues

Cost of recurring revenues for the six months ended December 31, 2017 increased by $9.9 million, or 25%, to $49.7 million from $39.8 million for the six months ended December 31, 2016. Cost of recurring revenues increased primarily as a result of the continued growth of our business, in particular, $3.8 million in additional employee-related costs resulting from additional personnel necessary to provide services to new and existing clients, $3.1 million in increased internal-use software amortization and $2.7 million in delivery and other processing-related fees. Recurring gross margin remained consistent at 69% for the six months ended December 31, 2016 and 2017.

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Cost of Implementation Services and Other

Cost of implementation services and other for the six months ended December 31, 2017 increased by $3.1 million, or 17%, to $22.1 million from $18.9 million for the six months ended December 31, 2016. The increase in cost of implementation services and other was primarily the result of $2.6 million of additional employee-related costs to implement our solutions for new and existing clients during the six months ended December 31, 2017.

Operating Expenses

Sales and Marketing

	Six Months Ended December 31,		Change	
	2016	2017	$	%
Sales and marketing	$ 35,746	$ 42,778	$ 7,032	20 %
Percentage of total revenues	26 %	25 %		

Sales and marketing expenses for the six months ended December 31, 2017 increased by $7.0 million, or 20%, to $42.8 million from $35.7 million for the six months ended December 31, 2016. The increase in sales and marketing expense was primarily the result of $5.5 million of additional employee-related costs from the expansion of our sales team (including management, sales engineers, direct sales, sales administration and sales lead generation support). The increase was also attributable to $1.0 million in additional stock-based compensation associated with our equity incentive plan.

Research and Development

	Six Months Ended December 31,		Change	
	2016	2017	$	%
Research and development	$ 14,523	$ 18,169	$ 3,646	25 %
Percentage of total revenues	11 %	11 %		

Research and development expenses for the six months ended December 31, 2017 increased by $3.6 million, or 25%, to $18.2 million from $14.5 million for the six months ended December 31, 2016. The increase in research and development expense was primarily the result of $4.1 million of additional employee-related costs related to additional development personnel, partially offset by higher year-over-year capitalized internal-use software costs of $1.1 million.

General and Administrative

	Six Months Ended December 31,		Change	
	2016	2017	$	%
General and administrative	$ 28,815	$ 34,110	$ 5,295	18 %
Percentage of total revenues	22 %	20 %		

General and administrative expenses for the six months ended December 31, 2017 increased by $5.3 million, or 18%, to $34.1 million from $28.8 million for the six months ended December 31, 2016. The increase in general and administrative expense was primarily the result of $2.1 million of additional employee-related costs, $2.0 million of increased occupancy costs incurred as a result of our requirement for additional office space and $0.6 million in additional stock-based compensation associated with our equity incentive plan.

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Other Income

	Six Months Ended December 31,		Change	
	2016	2017	$	%
Other income	$ 43	$ 250	$ 207	*
Percentage of total revenues	0 %	0 %		

*Not Meaningful

Other income for the six months ended December 31, 2017 was not materially different as compared to the six months ended December 31, 2016.

Income Tax Expense (Benefit)

	Six Months Ended December 31,		Change	
	2016	2017	$	%
Income tax expense (benefit)	$ 132	$ (76)	$ (208)	*
Percentage of total revenues	0 %	0 %		

*Not Meaningful

The difference in income tax expense (benefit) for the six months ended December 31, 2017 as compared to the six months ended December 31, 2016 was primarily due to the revaluation of deferred taxes arising from the Tax Cuts and Jobs Act.

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Quarterly Trends and Seasonality

Our overall operating results fluctuate from quarter to quarter as a result of a variety of factors, some of which are outside of our control. Our historical results should not be considered a reliable indicator of our future results of operations.

We experience fluctuations in revenues and related costs on a seasonal basis, which are primarily seen in our fiscal third quarter, which ends on March 31 of each year. Specifically, our recurring revenue is positively impacted in our fiscal third quarter as a result of our preparation of W-2 documents for our clients' employees in advance of tax filing requirements. The seasonal fluctuations in revenues also positively impact gross profits during our fiscal third quarter. Our historical results for our fiscal third quarter should not be considered a reliable indicator of our future results of operations. Our interest income earned on funds held for clients is also positively impacted during our fiscal third quarter as a result of our increased collection of funds held for clients. Certain payroll taxes are primarily collected during our fiscal third quarter and subsequently remitted.

Implementation revenues are also typically higher during our fiscal third quarter as many of our new clients elect to implement our services following a calendar year-end. Implementation gross profit varies on a quarterly basis as costs are generally fixed in the near-term, while revenues vary based on the number of new client implementations.

Critical Accounting Policies and Estimates

Our management's discussion and analysis of our financial condition and results of operations is based on our consolidated financial statements, which have been prepared in accordance with GAAP. The preparation of these consolidated financial statements requires us to make estimates and assumptions that affect the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities at the date of the consolidated financial statements, and the reported amounts of revenue and expenses. In accordance with GAAP, we base our estimates on historical experience and on various other assumptions that we believe are reasonable under the circumstances. Actual results might differ from these estimates under different assumptions or conditions and, to the extent that there are differences between our estimates and actual results, our future financial statement presentation, financial condition, results of operations and cash flows will be affected. We added a significant accounting policy related to the investment of funds held for clients in marketable securities starting in the first quarter of fiscal 2018. Refer to Note 2 of the Notes to the Unaudited Consolidated Financial Statements for additional detail around these investments. Our critical accounting policies and use of estimates are disclosed in our audited consolidated financial statements for the year ended June 30, 2017 included in our Annual Report on Form 10-K filed with the SEC on August 11, 2017.

Liquidity and Capital Resources

Our primary liquidity needs are related to the funding of general business requirements, including working capital requirements, research and development, and capital expenditures. As of December 31, 2017, our principal source of liquidity was $111.0 million of cash and cash equivalents.

In order to grow our business, we intend to increase our personnel and related expenses and to make significant investments in our platform, data centers and general infrastructure. The timing and amount of these investments will vary based on the rate at which we can add new clients and new personnel and the scale of our application development, data center and other activities. Many of these investments will occur in advance of our experiencing any direct benefit from them which could negatively impact our liquidity and cash flows during any particular period and may make it difficult to determine if we are effectively allocating our resources. However, we expect to fund our operations, capital expenditures and other investments principally with cash flows from operations, and to the extent that our liquidity needs exceed our cash from operations, we would look to our cash on hand and seek to establish borrowing capacity to satisfy those needs.

Our cash flows from investing and financing activities are influenced by the amount of funds held for clients which varies significantly from quarter to quarter. The balance of the funds we hold depends on our clients' payroll calendar, and therefore, such balance changes from period to period in accordance with the timing of each payroll cycle. Funds held for clients are primarily placed in demand deposit accounts with various financial institutions. We also invest

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a portion of the funds held for clients in highly liquid, investment-grade marketable securities. Funds held for clients are used for the repayment of client fund obligations.

We believe our current cash and cash equivalents and cash flow from operations will be sufficient to meet our working capital, capital expenditure and other investment requirements for at least the next 12 months.

The following table sets forth data regarding cash flows for the periods indicated:

	Six Months Ended December 31,	
	2016	2017
Net cash provided by operating activities	$ 15,390	$ 34,168
Cash flows from investing activities:		
Purchases of available-for-sale securities from funds held for clients	—	(95,207)
Proceeds from sales and maturities of available-for-sale securities from funds held for clients	—	23,181
Net change in funds held for clients' cash and cash equivalents	147,151	(331,078)
Capitalized internal-use software costs	(6,279)	(7,146)
Purchases of property and equipment	(10,038)	(7,998)
Lease allowances used for tenant improvements	—	(5,952)
Net cash provided by (used in) investing activities	130,834	(424,200)
Cash flows from financing activities:		
Net change in client fund obligations	(147,151)	403,243
Proceeds from employee stock purchase plan	1,823	2,045
Taxes paid related to net share settlement of equity awards	(5,135)	(7,697)
Net cash provided by (used in) financing activities	(150,463)	397,591
Net change in cash and cash equivalents	$ (4,239)	$ 7,559

Operating Activities

Net cash provided by operating activities was $15.4 million and $34.2 million for the six months ended December 31, 2016 and 2017, respectively. The increase in net cash provided by operating activities from the six months ended December 31, 2016 to the six months ended December 31, 2017 was primarily due to improved operating results after adjusting for non-cash items including stock-based compensation expense and depreciation and amortization expense. The increase was also due to $6.0 million received for tenant improvement allowances.

Investing Activities

Net cash provided by (used in) investing activities was $130.8 million and $(424.2) million for the six months ended December 31, 2016 and 2017, respectively.

Changes in net cash provided by (used in) investing activities are significantly influenced by the amount of funds held for clients at the end of a reporting period. Changes in the amount of funds held for clients from period to period will vary substantially as a result of the timing of payroll and tax obligations due. Our payroll processing activities involve the movement of significant funds from accounts of employers to employees and relevant taxing authorities. During fiscal 2017, we processed over $92 billion in payroll transactions. Though we debit a client's account prior to any disbursement on its behalf, there is a delay between our payment of amounts due to employees and taxing and other regulatory authorities and when the incoming funds from the client to cover these amounts payable actually clear into our operating accounts. We currently have agreements with nine banks to execute ACH and wire transfers to support our client payroll and tax services. We believe we have sufficient capacity under these ACH arrangements to handle our transactions for the foreseeable future. Fluctuations in the net change in funds held for clients' cash and cash equivalents are also impacted by the timing of purchases and sales and maturities of investments as we invest a portion of the funds held for clients in highly liquid, investment-grade marketable securities.

Excluding the net change in funds held for clients' cash and cash equivalents and purchases and proceeds from sales and maturities of available-for-sale securities from funds held for clients, our net cash used in investing activities was $16.3 million and $21.1 million for the six months ended December 31, 2016 and 2017, respectively. The change in

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net cash used in investing activities was primarily due to $6.0 million in lease allowances used for tenant improvements, partially offset by $2.0 million in fewer purchases of property and equipment during the six months ended December 31, 2017 as compared to December 31, 2016.

Financing Activities

Net cash provided by (used in) financing activities was $(150.5) million and $397.6 million for the six months ended December 31, 2016 and 2017, respectively. Excluding the net change in client fund obligations, net cash used in financing activities was $(3.3) million and $(5.7) million for the six months ended December 31, 2016 and 2017, respectively. The change in cash provided by (used in) financing activities, excluding the net change in client fund obligations, was primarily the result of higher taxes paid related to net share settlement of equity awards.

Contractual Obligations and Commitments

Our principal commitments consist of operating lease obligations. The following table summarizes our contractual obligations at December 31, 2017:

	Payment Due By Fiscal Period				
	Total	Less than 1 Year	1-3 Years	3-5 Years	More than 5 Years
Operating lease obligations	$ 114,062	$ 7,799	$ 17,737	$ 17,475	$ 71,051
Unconditional purchase obligations	1,827	1,382	445	—	—
	$ 115,889	$ 9,181	$ 18,182	$ 17,475	$ 71,051

Capital Expenditures

We expect to increase capital spending as we continue to grow our business and expand and enhance our operating facilities, data centers and technical infrastructure. Future capital requirements will depend on many factors, including our rate of sales growth. In the event that our sales growth or other factors do not meet our expectations, we may eliminate or curtail capital projects in order to mitigate the impact on our use of cash. Capital expenditures were $10.0 million and $8.0 million for the six months ended December 31, 2016 and 2017, respectively, exclusive of capitalized internal-use software costs of $6.3 million and $7.1 million for the same periods, respectively. During the first two quarters of fiscal 2018, we also spent $6.0 million on capital expenditures for which we received reimbursement from tenant improvement allowances.

Off-Balance Sheet Arrangements

We do not have any off-balance sheet arrangements that have or are reasonably likely to have a current or future effect on our financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources that may be material to investors.

New Accounting Pronouncements

Refer to Note 2 of the Notes to the Unaudited Consolidated Financial Statements for a discussion of recently issued accounting standards.

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Item 3. Quantitative and Qualitative Disclosures about Market Risk

We have operations solely in the United States and are exposed to market risks in the ordinary course of our business. These risks primarily include interest rate and certain other exposures as well as risks relating to changes in the general economic conditions in the United States. We have not used, nor do we intend to use, derivatives to mitigate the impact of interest rate or other exposure or for trading or speculative purposes.

Interest Rate Risk

As of December 31, 2017, we had cash and cash equivalents of $111.0 million and funds held for clients of $1,345.7 million. We deposit our cash and cash equivalents and significant portions of our funds held for clients in demand deposit accounts with various financial institutions. Starting in July 2017, we invested a portion of our funds held for clients in marketable securities including commercial paper, corporate bonds and asset-backed securities which were classified as available-for-sale securities as of December 31, 2017. Our investment policy is focused on generating higher yields from these investments while preserving liquidity and capital. However, as a result of our investing activities, we are exposed to changes in interest rates that may materially affect our financial statements.

In a falling rate environment, a decline in interest rates would decrease our interest income earned on both cash and cash equivalents and funds held for clients. An increase in the overall interest rate environment may cause the market value of portions of our funds held for clients invested in fixed rate available-for-sale securities to decline. If we are forced to sell some or all of these securities at lower market values, we may incur investment losses. However, because we classify all marketable securities as available-for-sale, no gains or losses are recognized due to changes in interest rates until such securities are sold or decreases in fair value are deemed to be other-than-temporary. We have not recorded any other-than-temporary impairment losses to date.

Based upon a sensitivity model that measures market value changes caused by interest rate fluctuations, an immediate 25-basis point increase in interest rates would have resulted in a decrease in the market value of our available-for-sale securities included in funds held for clients by $0.1 million as of December 31, 2017. A 25-basis point decrease in interest rates would have resulted in a $0.1 million increase in the market value of our available-for-sale securities included in funds held for clients as of December 31, 2017. Fluctuations in the value of our available-for-sale securities caused by a change in interest rates are recorded in other comprehensive income and are only realized if we sell the underlying securities.

Inflation Risk

We do not believe that inflation has had a material effect on our business, financial condition or results of operations. Nonetheless, if our costs were to become subject to significant inflationary pressures, we may not be able to fully offset such higher costs through price increases. Our inability or failure to do so could harm our business, financial condition and results of operations.

Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

The term “disclosure controls and procedures,” as defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act refers to controls and procedures that are designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC’s rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that such information is accumulated and communicated to a company’s management, including its principal executive and principal financial officers, as appropriate to allow timely decisions regarding required disclosure.

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Our management, with the participation of our Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of our disclosure controls and procedures as of December 31, 2017, the end of the period covered by this Quarterly Report on Form 10-Q. Based upon such evaluation, our Chief Executive Officer and Chief Financial Officer have concluded that our disclosure controls and procedures were effective as of such date.

Changes in Internal Control over Financial Reporting

There were no changes in our internal control over financial reporting during the three month period covered by this Quarterly Report on Form 10-Q that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

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PART II

OTHER INFORMATION

Item 1. Legal Proceedings

From time to time, we may become involved in litigation related to claims arising from the ordinary course of our business. We believe that there are no claims or actions pending or threatened against us, the ultimate disposition of which would have a material adverse effect on us.

Item 1A. Risk Factors.

Our business, prospects, financial condition or operating results could be materially adversely affected by any of these risks, as well as other risks not currently known to us or that are currently considered immaterial. The trading price of our common stock could decline due to any of the risks and uncertainties described below, and you may lose all or part of your investment. In assessing these risks, you should also refer to the other information contained in this Quarterly Report on Form 10-Q, including our consolidated financial statements and related notes.

Our quarterly operating results have fluctuated in the past and may continue to fluctuate, causing the value of our common stock to decline substantially.

Our quarterly operating results may fluctuate due to a variety of factors, many of which are outside of our control. As a result, comparing our operating results on a period-to-period basis may not be meaningful. Moreover, our stock price might be based on expectations of future performance that are unrealistic or that we might not meet and, if our revenue or operating results fall below such expectations, the price of our common stock could decline substantially.

Our number of new clients typically increases more during our third fiscal quarter ending March 31 than during the rest of our fiscal year, primarily because many new clients prefer to start using our payroll and human capital management, or HCM, solutions at the beginning of a calendar year. In addition, client funds and year-end activities are traditionally higher during our third fiscal quarter. As a result of these factors, our total revenue and expenses have historically grown disproportionately during our third fiscal quarter as compared to other quarters.

In addition to other risk factors listed in this section, some of the important factors that may cause fluctuations in our quarterly operating results include:

- The extent to which our products achieve or maintain market acceptance;
- Our ability to introduce new products and enhancements and updates to our existing products on a timely basis;
- Competitive pressures and the introduction of enhanced products and services from competitors;
- Changes in client budgets and procurement policies;
- The amount and timing of our investment in research and development activities and whether such investments are capitalized or expensed as incurred;
- The number of our clients' employees;
- Timing of recognition of revenues and expenses;
- Client renewal rates;
- Seasonality in our business;
- Technical difficulties with our products or interruptions in our services;

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- Our ability to hire and retain qualified personnel;

- A repeal of or changes to the laws and regulations related to the products and services which we offer;

- Changes in accounting principles; and

- Unforeseen legal expenses, including litigation and settlement costs.

The majority of our agreements with clients do not have a specified term and are generally cancellable by our clients upon 60 days' or less notice. If a significant number of clients elected to terminate their agreements with us, our operating results and our business would be adversely affected.

In addition, a significant portion of our operating expenses are related to compensation and other items which are relatively fixed in the short-term, and we plan expenditures based in part on our expectations regarding future needs and opportunities. Accordingly, changes in our business or revenue shortfalls could decrease our gross and operating margins and could cause significant changes in our operating results from period to period. If this occurs, the trading price of our common stock could fall substantially, either suddenly or over time.

Our operating results for previous fiscal quarters are not necessarily indicative of our operating results for the full fiscal years or for any future periods. We believe that, due to the underlying factors for quarterly fluctuations, quarter-to-quarter comparisons of our operations are not necessarily meaningful and that such comparisons should not be relied upon as indications of future performance.

We have incurred losses in the past, and we may not be able to sustain profitability for the foreseeable future.

We incurred net losses of $7,110,000, $13,972,000 and $3,851,000 in fiscal 2014, fiscal 2015 and fiscal 2016, respectively. While we generated net income in fiscal 2017, it does not ensure that we will earn continued net income in future periods. We have been growing our number of clients rapidly, and as we do so, we incur significant sales and marketing, services and other related expenses. Our profitability will be significantly influenced by our ability to attain sufficient scale and productivity to achieve recurring revenues that are sufficient to support the incremental costs to obtain and support new clients. We intend for the foreseeable future to continue to focus predominately on adding new clients, and we cannot predict when we will achieve sustained profitability, if at all. We also expect to make other significant expenditures and investments in research and development to expand and improve our product offerings and technical infrastructure. In addition, we incur significant legal, accounting and other expenses in order to comply with the rules and regulations to which we are subject to as a public company. These increased expenditures have made it harder for us to achieve and maintain profitability. We also may incur losses in the future for a number of other unforeseen reasons. Accordingly, we may incur losses in the foreseeable future.

Failure to manage our growth effectively could increase our expenses, decrease our revenue, and prevent us from implementing our business strategy.

We have been rapidly growing our revenue and number of clients, and we will seek to do the same for the foreseeable future. However, the growth in our number of clients puts significant strain on our business, requires significant capital expenditures and increases our operating expenses. To manage this growth effectively, we must attract, train, and retain a significant number of qualified sales, implementation, client service, software development, information technology and management personnel. We also must maintain and enhance our technology infrastructure and our financial and accounting systems and controls. If we fail to effectively manage our growth or we over-invest or under-invest in our business, our business and results of operations could suffer from the resultant weaknesses in our infrastructure, systems or controls. We could also suffer operational mistakes, a loss of business opportunities and employee losses. If our management is unable to effectively manage our growth, our expenses might increase more than expected, our revenue could decline or might grow more slowly than expected, and we might be unable to implement our business strategy.

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The markets in which we participate are highly competitive, and if we do not compete effectively, our operating results could be adversely affected.

The market for payroll and HCM solutions is fragmented, highly competitive and rapidly changing. Our competitors vary for each of our solutions, and include enterprise-focused software providers, such as Ultimate Software Group, Inc., Workday, Inc., SAP AG, Oracle Corporation and Ceridian Corporation, payroll service providers, such as Automatic Data Processing, Inc., Paychex, Inc., Paycom Software, Inc., Paycor, Inc. and other regional providers, and HCM point solutions, such as Cornerstone OnDemand, Inc.

Several of our competitors are larger, have greater name recognition, longer operating histories and significantly greater resources than we do. Many of these competitors are able to devote greater resources to the development, promotion and sale of their products and services. Furthermore, our current or potential competitors may be acquired by third parties with greater available resources and the ability to initiate or withstand substantial price competition. As a result, our competitors may be able to develop products and services better received by our markets or may be able to respond more quickly and effectively than we can to new or changing opportunities, technologies, regulations or client requirements.

In addition, current and potential competitors have established, and might in the future establish, partner or form other cooperative relationships with vendors of complementary products, technologies or services to enable them to offer new products and services, to compete more effectively or to increase the availability of their products in the marketplace. New competitors or relationships might emerge that have greater market share, a larger client base, more widely adopted proprietary technologies, greater marketing expertise, greater financial resources, and larger sales forces than we have, which could put us at a competitive disadvantage. In light of these advantages, current or potential clients might accept competitive offerings in lieu of purchasing our offerings. We expect intense competition to continue for these reasons, and such competition could negatively impact our sales, profitability or market share.

If we do not continue to innovate and deliver high-quality, technologically advanced products and services, we will not remain competitive and our revenue and operating results could suffer.

The market for our solutions is characterized by rapid technological advancements, changes in client requirements, frequent new product introductions and enhancements and changing industry standards. The life cycles of our products are difficult to estimate. Rapid technological changes and the introduction of new products and enhancements by new or existing competitors could undermine our current market position.

Our success depends in substantial part on our continuing ability to provide products and services that medium-sized organizations will find superior to our competitors' offerings and will continue to use. We intend to continue to invest significant resources in research and development in order to enhance our existing products and services and introduce

new high-quality products that clients will want. If we are unable to predict user preferences or industry changes, or if we are unable to modify our products and services on a timely basis or to effectively bring new products to market, our sales may suffer.

In addition, we may experience difficulties with software development, industry standards, design, or marketing that could delay or prevent our development, introduction or implementation of new solutions and enhancements. The introduction of new solutions by competitors, the emergence of new industry standards or the development of entirely new technologies to replace existing offerings could render our existing or future solutions obsolete.

We may not have sufficient resources to make the necessary investments in software development and we may experience difficulties that could delay or prevent the successful development, introduction or marketing of new products or enhancements. In addition, our products or enhancements may not meet the increasingly complex client requirements of the marketplace or achieve market acceptance at the rate we expect, or at all. Any failure by us to anticipate or respond adequately to technological advancements, client requirements and changing industry standards, or any significant delays in the development, introduction or availability of new products or enhancements, could undermine our current market position.

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If we are unable to release periodic updates on a timely basis to reflect changes in tax, benefit and other laws and regulations that our products help our clients address, the market acceptance of our products may be adversely affected and our revenues could decline.

Our solutions are affected by changes in tax, benefit and other laws and regulations and generally must be updated regularly to maintain their accuracy and competitiveness. Although we believe our SaaS platform provides us with flexibility to release updates in response to these changes, we cannot be certain that we will be able to make the necessary changes to our solutions and release updates on a timely basis, or at all. Failure to do so could have an adverse effect on the functionality and market acceptance of our solutions. Changes in tax, benefit and other laws and regulations could require us to make significant modifications to our products or delay or cease sales of certain products, which could result in reduced revenues or revenue growth and our incurring substantial expenses and write-offs.

Our business may be adversely impacted if the Patient Protection and Affordable Care Act, or the ACA, is repealed in its entirety or certain aspects of the ACA are repealed or changed.

The ACA remains subject to legislative efforts to repeal, modify or delay the implementation of all or certain aspects of the law. Generally, if the ACA is repealed or modified in whole or in part, or if implementation of certain aspects of the ACA is delayed, such repeal, modification or delay could adversely impact our existing and future business and operating results. For example, any such repeal, modification or delay could negatively impact the revenue we currently generate from our ACA Compliance solution as well as overall gross margins. While we expect continued challenges to the ACA, at this time we are unable to more precisely predict the full impact of any repeal, modification or delay in the implementation of the ACA.

Because of the way we recognize our revenue and our expenses over varying periods, changes in our business may not be immediately reflected in our financial statements.

We recognize our revenue as services are performed. The amount of revenue we recognize in any particular period is derived in significant part based on the number of employees of our clients served by our solutions. As a result, our revenue is dependent in part on the success of our clients. The effect on our revenue of significant changes in sales of our solutions or in our clients' businesses may not be fully reflected in our results of operations until future periods.

We recognize our expenses over varying periods based on the nature of the expense. In particular, we recognize implementation costs and sales commissions as they are incurred even though we recognize revenue as we perform services over extended periods. When a client terminates its relationship with us, we may not have derived enough revenue from that client to cover associated implementation costs. As a result, we may report poor operating results due to higher implementation costs and sales commissions in a period in which we experience strong sales of our

solutions. Alternatively, we may report better operating results due to lower implementation costs and sales commissions in a period in which we experience a slowdown in sales. As a result, our expenses fluctuate as a percentage of revenue, and changes in our business generally may not be immediately reflected in our results of operations.

If our security measures are breached or unauthorized access to client data or funds is otherwise obtained, our solutions may be perceived as not being secure, clients may reduce the use of or stop using our solutions and we may incur significant liabilities.

Our solutions involve the storage and transmission of our clients' and their employees' proprietary and confidential information. This information includes bank account numbers, tax return information, social security numbers, benefit information, retirement account information, payroll information and system passwords. In addition, we collect and maintain personal information on our own employees in the ordinary course of our business. Finally, our business involves the storage and transmission of funds from the accounts of our clients to their employees, taxing and regulatory authorities and others. As a result, unauthorized access or security breaches of our systems or the systems of our clients could result in the unauthorized disclosure of confidential information, theft, litigation, indemnity obligations and other significant liabilities. Because the techniques used to obtain unauthorized access or sabotage systems change frequently and generally are not identified until they are employed, we may be unable to anticipate these techniques or to implement adequate preventative measures in advance. While we have security measures and controls in place to protect confidential information, prevent data loss, theft and other security breaches, including penetration tests of our systems by independent third parties, if our security measures are breached, our business could be substantially harmed and we

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could incur significant liabilities. Any such breach or unauthorized access could negatively affect our ability to attract new clients, cause existing clients to terminate their agreements with us, result in reputational damage and subject us to lawsuits, regulatory fines or other actions or liabilities which could materially and adversely affect our business and operating results.

There can be no assurance that the limitations of liability in our contracts would be enforceable or adequate or would otherwise protect us from any such liabilities or damages with respect to any particular claim related to a breach or unauthorized access. We also cannot be sure that our existing general liability insurance coverage and coverage for errors or omissions will continue to be available on acceptable terms or will be available in sufficient amounts to cover one or more large claims, or that the insurer will not deny coverage as to any future claim. The successful assertion of one or more large claims against us that exceed available insurance coverage, or the occurrence of changes in our insurance policies, including premium increases or the imposition of large deductible or co-insurance requirements, could have a material adverse effect on our business, financial condition and results of operations.

If we fail to adequately expand our direct sales force with qualified and productive persons, we may not be able to grow our business effectively.

We primarily sell our products and implementation services through our direct sales force. To grow our business, we intend to focus on growing our client base for the foreseeable future. Our ability to add clients and to achieve revenue growth in the future will depend upon our ability to grow and develop our direct sales force and on their ability to productively sell our solutions. Identifying and recruiting qualified personnel and training them in the use of our software require significant time, expense and attention. The amount of time it takes for our sales representatives to be fully-trained and to become productive varies widely. In addition, if we hire sales representatives from competitors or other companies, their former employers may attempt to assert that these employees have breached their legal obligations, resulting in a diversion of our time and resources.

If our sales organization does not perform as expected, our revenues and revenue growth could suffer. In addition, if we are unable to hire, develop and retain talented sales personnel, if our sales force becomes less efficient as it grows or if new sales representatives are unable to achieve desired productivity levels in a reasonable period of time, we may not be able to grow our client base and revenues and our sales and marketing expenses may increase.

If our referral network participants reduce their referrals to us, we may not be able to grow our client base or revenues in the future.

Referrals from third-party service providers, including 401(k) advisors, benefits administrators, insurance brokers, third-party administrators and HR consultants, represent a significant source of potential clients for our products and implementation services. For example, we estimate that approximately 30% of our new sales in fiscal 2017 were

referred to us from our referral network participants. In most cases, our relationships with referral network participants are informal, although in some cases, we have formalized relationships where we are a recommended vendor for their client.

Participants in our referral network are generally under no contractual obligation to continue to refer business to us, and we do not intend to seek contractual relationships with these participants. In addition, these participants are generally not compensated for referring potential clients to us, and may choose to instead refer potential clients to our competitors. Our ability to achieve revenue growth in the future will depend, in part, upon continued referrals from our network.

There can be no assurance that we will be successful in maintaining, expanding or developing our referral network. If our relationships with participants in our referral network were to deteriorate or if any of our competitors enter into strategic relationships with our referral network participants, sales leads from these participants could be reduced or cease entirely. If we are not successful, we may lose sales opportunities and our revenues and profitability could suffer.

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If the market for cloud-based payroll and HCM solutions among medium-sized organizations develops more slowly than we expect or declines, our business could be adversely affected.

We believe that the market for cloud-based payroll and HCM solutions is not as mature among medium-sized organizations as the market for outsourced services or on-premise software and services. It is not certain that cloud-based solutions will achieve and sustain high levels of client demand and market acceptance. Our success will depend to a substantial extent on the widespread adoption by medium-sized organizations of cloud-based computing in general, and of payroll and other HCM applications in particular. It is difficult to predict client adoption rates and demand for our solutions, the future growth rate and size of the cloud-based market or the entry of competitive solutions. The expansion of the cloud-based market depends on a number of factors, including the cost, performance, and perceived value associated with cloud-based computing, as well as the ability of cloud-based solutions to address security and privacy concerns. If other cloud-based providers experience security incidents, loss of client data, disruptions in delivery or other problems, the market for cloud-based applications as a whole, including our solutions, may be negatively affected. If cloud-based payroll and HCM solutions do not achieve widespread adoption among medium-sized organizations, or there is a reduction in demand for cloud-based computing caused by a lack of client acceptance, technological challenges, weakening economic conditions, security or privacy concerns, competing technologies and products, decreases in corporate spending or otherwise, it could result in a loss of clients, decreased revenues and an adverse impact on our business.

We typically pay employees and may pay taxing authorities amounts due for a payroll period before a client's electronic funds transfers are finally settled to our account. If client payments are rejected by banking institutions or otherwise fail to clear into our accounts, we may require additional sources of short-term liquidity and our operating results could be adversely affected.

Our payroll processing business involves the movement of significant funds from the account of a client to employees and relevant taxing authorities. For example, in fiscal 2017 we processed over $92 billion in payroll transactions. Though we debit a client's account prior to any disbursement on its behalf, due to Automated Clearing House, or ACH, banking regulations, funds previously credited could be reversed under certain circumstances and timeframes after our payment of amounts due to employees and taxing and other regulatory authorities. There is therefore a risk that the employer's funds will be insufficient to cover the amounts we have already paid on its behalf. While such shortage and accompanying financial exposure has only occurred in very limited instances in the past, should clients default on their payment obligations in the future, we might be required to advance substantial amounts of funds to cover such obligations. In such an event, we may be required to seek additional sources of short-term liquidity, which may not be available on reasonable terms, if at all, and our operating results and our liquidity could be adversely affected and our banking relationships could be harmed.

Adverse changes in economic or political conditions could adversely affect our operating results and our business.

Our recurring revenues are based in part on the number of our clients' employees. As a result, we are subject to risks arising from adverse changes in economic and political conditions. The state of the economy and the rate of employment, which deteriorated in the recent broad recession, may deteriorate further in the future. If weakness in the economy continues or worsens, many clients may reduce their number of employees and delay or reduce technology purchases. This could also result in reductions in our revenues and sales of our products, longer sales cycles, increased price competition and clients' purchasing fewer solutions than they have in the past. Any of these events would likely harm our business, results of operations, financial condition and cash flows from operations.

Trade, monetary and fiscal policies, and political and economic conditions may substantially change, and credit markets may experience periods of constriction and volatility. When there is a slowdown in the economy, employment levels and interest rates may decrease with a corresponding impact on our businesses. Clients may react to worsening conditions by reducing their spending on payroll and other HCM solutions or renegotiating their contracts with us. We have agreements with various large banks to execute ACH and wire transfers as part of our client payroll and tax services. While we have contingency plans in place for bank failures, a failure of one of our banking partners or a systemic shutdown of the banking industry could result in the loss of client funds or impede us from accessing and processing funds on our clients' behalf, and could have an adverse impact on our business and liquidity.

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If the banks that currently provide ACH and wire transfers fail to properly transmit ACH or terminate their relationship with us or limit our ability to process funds or we are not able to increase our ACH capacity with our existing and new banks, our ability to process funds on behalf of our clients and our financial results and liquidity could be adversely affected.

We currently have agreements with nine banks to execute ACH and wire transfers to support our client payroll and tax services. If one or more of the banks fails to process ACH transfers on a timely basis, or at all, then our relationship with our clients could be harmed and we could be subject to claims by a client with respect to the failed transfers. In addition, these banks have no obligation to renew their agreements with us on commercially reasonable terms, if at all. If these banks terminate their relationships with us or restrict the dollar amounts of funds that they will process on behalf of our clients, their doing so may impede our ability to process funds and could have an adverse impact on our financial results and liquidity.

We depend on our senior management team and other key employees, and the loss of these persons or an inability to attract and retain highly skilled employees could adversely affect our business.

Our success depends largely upon the continued services of our key executive officers, including Steven R. Beauchamp, our Chief Executive Officer. We also rely on our leadership team in the areas of research and development, sales, services and general and administrative functions. From time to time, there may be changes in our executive management team resulting from the hiring or departure of executives, which could disrupt our business. While we have employment agreements with our executive officers, including Mr. Beauchamp, these employment agreements do not require them to continue to work for us for any specified period and, therefore, they could terminate their employment with us at any time. The loss of one or more of our executive officers or key employees could have an adverse effect on our business.

If we are unable to recruit and retain highly-skilled product development and other technical persons, our ability to develop and support widely-accepted products could be impaired and our business could be harmed.

We believe that to grow our business and be successful, we must continue to develop products that are technologically-advanced, are highly integrable with third-party services, provide significant mobility capabilities and have pleasing and intuitive user experiences. To do so, we must attract and retain highly qualified personnel, particularly employees with high levels of experience in designing and developing software and Internet-related products and services. Competition for these personnel in the greater Chicago area and elsewhere is intense. If we fail to attract new personnel or fail to retain and motivate our current personnel, our business and future growth prospects could be severely harmed. We follow a practice of hiring the best available candidates wherever located, but as we grow our business, the productivity of our product development and other research and development may be adversely affected. In addition, if we hire employees from competitors or other companies, their former employers may attempt to assert that these employees have breached their legal obligations, resulting in a diversion of our time and resources.

The sale and support of products and the performance of related services by us entail the risk of product or service liability claims, which could significantly affect our financial results.

Clients use our products in connection with the preparation and filing of tax returns and other regulatory reports. If any of our products contain errors that produce inaccurate results upon which users rely, or cause users to misfile or fail to file required information, we could be subject to liability claims from users. Our agreements with our clients typically contain provisions intended to limit our exposure to such claims, but such provisions may not be effective in limiting our exposure. Contractual limitations we use may not be enforceable and may not provide us with adequate protection against product liability claims in certain jurisdictions. A successful claim for product or service liability brought against us could result in substantial cost to us and divert management's attention from our operations.

Privacy concerns and laws or other domestic regulations may reduce the effectiveness of our applications and adversely affect our business.

Our clients collect, use and store personal or identifying information regarding their employees and their family members in our solutions. Federal and state government bodies and agencies have adopted, are considering adopting, or may adopt laws and regulations regarding the collection, use, storage and disclosure of such personal information. The

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costs of compliance with, and other burdens imposed by, such laws and regulations that are applicable to our clients' businesses may limit the use and adoption of our applications and reduce overall demand, or lead to significant fines, penalties or liabilities for any noncompliance with such privacy laws. Even the perception of privacy concerns, whether or not valid, may inhibit market adoption of our solutions.

All of these legislative and regulatory initiatives may adversely affect our clients' ability to process, handle, store, use and transmit demographic and personal information regarding their employees and family members, which could reduce demand for our solutions.

In addition to government activity, privacy advocacy groups and the technology and other industries are considering various new, additional or different self-regulatory standards that may place additional burdens on us. If the processing of personal information were to be curtailed in this manner, our products would be less effective, which may reduce demand for our applications and adversely affect our business.

Our business could be adversely affected if we do not effectively implement our solutions or our clients are not satisfied with our implementation services.

Our ability to deliver our payroll and HCM solutions depends on our ability to effectively implement and to transition to, and train our clients on, our solutions. We do not recognize revenue from new clients until they process their first payroll. Further, the majority of our agreements with our clients are generally terminable by the clients on 60 days' or less notice. If a client is not satisfied with our implementation services, the client could terminate its agreement with us before we have recovered our costs of implementation services, which would adversely affect our results of operations and cash flows. In addition, negative publicity related to our client relationships, regardless of its accuracy, may further damage our business by affecting our ability to compete for new business with current and prospective clients.

Our business could be affected if we are unable to accommodate increased demand for our implementation services resulting from growth in our business.

We may be unable to respond quickly enough to accommodate increased client demand for implementation services driven by our growth. The implementation process is the first substantive interaction with a new client. As a predicate to providing knowledgeable implementation services, we must have a sufficient number of personnel dedicated to that process. In order to ensure that we have sufficient employees to implement our solutions, we must closely coordinate hiring of personnel with our projected sales for a particular period. Because our sales cycle is typically only three to six weeks long, we may not be successful in coordinating hiring of implementation personnel to meet increased demand for our implementation services. Increased demand for implementation services without a corresponding staffing increase of qualified personnel could adversely affect the quality of services provided to new clients, and our

business and our reputation could be harmed.

Any failure to offer high-quality client services may adversely affect our relationships with our clients and our financial results.

Once our applications are deployed, our clients depend on our client service organization to resolve issues relating to our solutions. The majority of our clients are medium-sized organizations with limited personnel and resources to address payroll and other HCM related issues. These clients rely on us more so than larger companies with greater internal resources and expertise. High-quality client services are important for the successful marketing and sale of our products and for the retention of existing clients. If we do not help our clients quickly resolve issues and provide effective ongoing support, our ability to sell additional products to existing clients would suffer and our reputation with existing or potential clients would be harmed.

In addition, our sales process is highly dependent on our applications and business reputation and on positive recommendations from our existing clients. Any failure to maintain high-quality client services, or a market perception that we do not maintain high-quality client services, could adversely affect our reputation, our ability to sell our solutions to existing and prospective clients, and our business, operating results and financial position.

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If we fail to manage our technical operations infrastructure, our existing clients may experience service outages and our new clients may experience delays in the deployment of our applications.

We have experienced significant growth in the number of users, transactions and data that our operations infrastructure supports. We seek to maintain sufficient excess capacity in our data center and other operations infrastructure to meet the needs of all of our clients. We also seek to maintain excess capacity to facilitate the rapid provision of new client deployments and the expansion of existing client deployments. In addition, we need to properly manage our technological operations infrastructure in order to support version control, changes in hardware and software parameters and the evolution of our applications. However, the provision of new hosting infrastructure requires significant lead time. We have experienced, and may in the future experience, website disruptions, outages and other performance problems. These problems may be caused by a variety of factors, including infrastructure changes, human or software errors, viruses, security attacks, fraud, spikes in client usage and denial of service issues. In some instances, we may not be able to identify the cause or causes of these performance problems within an acceptable period of time. If we do not accurately predict our infrastructure requirements, our existing clients may experience service outages that may subject us to financial penalties, financial liabilities and client losses. If our operations infrastructure fails to keep pace with increased sales, clients may experience delays as we seek to obtain additional capacity, which could adversely affect our reputation and our revenues.

In addition, our ability to deliver our cloud-based applications depends on the development and maintenance of Internet infrastructure by third parties. This includes maintenance of a reliable network backbone with the necessary speed, data capacity, bandwidth capacity, and security. Our services are designed to operate without interruption. However, we have experienced and expect that we will experience future interruptions and delays in services and availability from time to time. In the event of a catastrophic event with respect to one or more of our systems, we may experience an extended period of system unavailability, which could negatively impact our relationship with clients. To operate without interruption, both we and our clients must guard against:

- Damage from fire, power loss, natural disasters and other force majeure events outside our control;
- Communications failures;
- Software and hardware errors, failures and crashes;
- Security breaches, computer viruses, hacking, denial-of-service attacks and similar disruptive problems; and
- Other potential interruptions.

We also rely on computer hardware purchased or leased and software licensed from third parties in order to offer our services. These licenses and hardware are generally commercially available on varying terms. However, it is possible

that this hardware and software might not continue to be available on commercially reasonable terms, or at all. Any loss of the right to use any of this hardware or software could result in delays in the provisioning of our services until equivalent technology is either developed by us, or, if available, is identified, obtained and integrated.

Furthermore, our payroll application is essential to our clients' timely payment of wages to their employees. Any interruption in our service may affect the availability, accuracy or timeliness of these programs and could damage our reputation, cause our clients to terminate their use of our application, require us to indemnify our clients against certain losses due to our own errors and prevent us from gaining additional business from current or future clients.

Any disruption in the operation of our data centers could adversely affect our business.

We host our solutions at a third-party facility in Franklin Park, Illinois and utilize another third-party facility in Kenosha, Wisconsin for backup and disaster recovery. We also may decide to employ additional offsite data centers in the future to accommodate growth.

Problems faced by our data center locations, with the telecommunications network providers with whom we or they contract, or with the systems by which our telecommunications providers allocate capacity among their clients,

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including us, could adversely affect the availability and processing of our solutions and related services and the experience of our clients. If our data centers are unable to keep up with our growing needs for capacity, this could have an adverse effect on our business and cause us to incur additional expense. In addition, any financial difficulties faced by our third-party data center's operator or any of the service providers with whom we or they contract may have negative effects on our business, the nature and extent of which are difficult to predict. Any changes in service levels at our third-party data center or any errors, defects, disruptions or other performance problems with our applications could adversely affect our reputation and may damage our clients' stored files or result in lengthy interruptions in our services. Interruptions in our services might reduce our revenues, subject us to potential liability or other expenses or adversely affect our renewal rates.

In addition, while we own, control and have access to our servers and all of the components of our network that are located in our backup data centers, we do not control the operation of these facilities. The operators of our third party data center facilities have no obligations to renew their agreements with us on commercially reasonable terms, or at all. If we are unable to renew these agreements on commercially reasonable terms, or if the data center operators are acquired, we may be required to transfer our servers and other infrastructure to new data center facilities, and we may incur costs and experience service interruption in doing so.

Our software might not operate properly, which could damage our reputation, give rise to claims against us, or divert application of our resources from other purposes, any of which could harm our business and operating results.

Our payroll and HCM software is complex and may contain or develop undetected defects or errors, particularly when first introduced or as new versions are released. Despite extensive testing, from time to time we have discovered defects or errors in our products. In addition, because changes in employer and legal requirements and practices relating to benefits are frequent, we discover defects and errors in our software and service processes in the normal course of business compared against these requirements and practices. Material performance problems or defects in our products and services might arise in the future, which could have an adverse impact on our business and client relationship and subject us to claims.

Moreover, software development is time-consuming, expensive and complex. Unforeseen difficulties can arise. We might encounter technical obstacles, and it is possible that we discover problems that prevent our products from operating properly. If they do not function reliably or fail to achieve client expectations in terms of performance, clients could cancel their agreements with us and/or assert liability claims against us. This could damage our reputation, impair our ability to attract or maintain clients and harm our results of operations.

Defects and errors and any failure by us to identify and address them could result in delays in product introductions and updates, loss of revenue or market share, liability to clients or others, failure to achieve market acceptance or expansion, diversion of development and other resources, injury to our reputation, and increased service and maintenance costs. Defects or errors in our product or service processes might discourage existing or potential clients from purchasing from us. Correction of defects or errors could prove to be impossible or impracticable. The costs

incurred in correcting any defects or errors or in responding to resulting claims or liability might be substantial and could adversely affect our operating results.

Because of the large amount of data that we collect and manage, it is possible that hardware failures or errors in our systems could result in data loss or corruption, or cause the information that we collect to be incomplete or contain inaccuracies that our clients, their employees and taxing and other regulatory authorities regard as significant. The costs incurred in correcting any errors or in responding to regulatory authorities or to resulting claims or liability might be substantial and could adversely affect our operating results.

We maintain insurance, but our insurance may be inadequate or may not be available in the future on acceptable terms, or at all. In addition, our policy may not cover all claims made against us and defending a suit, regardless of its merit, could be costly and divert management’s attention.

Our clients might assert claims against us in the future alleging that they suffered damages due to a defect, error, or other failure of our product or service processes. A product liability claim and errors or omissions claim could subject us to significant legal defense costs and adverse publicity regardless of the merits or eventual outcome of such a claim.

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Client funds that we hold are subject to market, interest rate, credit and liquidity risks. The loss of these funds could have an adverse impact on our business.

We invest funds held for our clients in liquid, investment-grade marketable securities such as corporate bonds, commercial paper, and asset-backed securities, money market securities, and other cash equivalents. We follow an established client fund investment policy and set of guidelines to monitor and help mitigate our exposure to liquidity and credit risks. Nevertheless, our client fund assets are subject to general market, interest rate, credit, and liquidity risks. These risks may be exacerbated, individually or in unison, during periods of unusual financial market volatility. Any loss of or inability to access client funds could have an adverse impact on our cash position and results of operations and could require us to obtain additional sources of liquidity.

In addition, these funds are held in consolidated accounts in trust on behalf of our clients, and as a result the aggregate amounts in the accounts exceed the applicable federal deposit insurance limits. We believe that since such funds are deposited in trust on behalf of our clients, the Federal Deposit Insurance Corporation, or the FDIC, would treat those funds as if they had been deposited by each of the clients themselves and insure each client's funds up to the applicable deposit insurance limits. If the FDIC were to take the position that it is not obligated to provide deposit insurance for our clients' funds or if the reimbursement of these funds were delayed, our business and our clients could be materially harmed.

If we are required to collect sales and use taxes in additional jurisdictions, we might be subject to liability for past sales and our future sales may decrease. Adverse tax laws or regulations could be enacted or existing laws could be applied to us or our clients, which could increase the costs of our services and adversely impact our business.

The application of federal, state, and local tax laws to services provided electronically is evolving. New income, sales, use or other tax laws, statutes, rules, regulations or ordinances could be enacted at any time (possibly with retroactive effect), and could be applied solely or disproportionately to services provided over the Internet. These enactments could adversely affect our sales activity due to the inherent cost increase the taxes would represent and ultimately result in a negative impact on our operating results and cash flows.

In addition, existing tax laws, statutes, rules, regulations or ordinances could be interpreted, changed, modified or applied adversely to us (possibly with retroactive effect), which could require us or our clients to pay additional tax amounts, as well as require us or our clients to pay fines or penalties and interest for past amounts.

For example, we might lose sales or incur significant expenses if states successfully impose broader guidelines on state sales and use taxes. A successful assertion by one or more states requiring us to collect sales or other taxes on our software or provision of our services could result in substantial tax liabilities for past transactions and otherwise harm our business. Each state has different rules and regulations governing sales and use taxes, and these rules and

regulations are subject to varying interpretations that change over time. We review these rules and regulations periodically and, when we believe we are subject to sales and use taxes in a particular state, we may voluntarily engage state tax authorities in order to determine how to comply with that state's rules and regulations. We cannot assure you that we will not be subject to sales and use taxes or related penalties for past sales in states where we currently believe no such taxes are required.

Vendors of services, like us, are typically held responsible by taxing authorities for the collection and payment of any applicable sales and similar taxes. If one or more taxing authorities determines that taxes should have, but have not, been paid with respect to our services, we might be liable for past taxes in addition to taxes going forward. Liability for past taxes might also include substantial interest and penalty charges. Our clients typically pay us for applicable sales and similar taxes. Nevertheless, our clients might be reluctant to pay back taxes and might refuse responsibility for interest or penalties associated with those taxes. If we are required to collect and pay back taxes and the associated interest and penalties, and if our clients fail or refuse to reimburse us for all or a portion of these amounts, we will incur unplanned expenses that may be substantial. Moreover, imposition of such taxes on us going forward will effectively increase the cost of our services to our clients and might adversely affect our ability to retain existing clients or to gain new clients in the areas in which such taxes are imposed.

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We may experience negative or unforeseen tax consequences.

In December 2017, both houses of the U.S. Congress passed legislation, known as the Tax Cuts and Jobs Act of 2017, that was approved and signed into law. This legislation could have a material benefit or material adverse impact on our effective tax rate, tax expense and cash flow. We are in the process of evaluating the potential aggregate impact the enactment of this passed legislation will have on our financial condition, cash flows and results of operations. Any benefits associated with lower U.S. corporate tax rates could be reduced or offset by other tax changes adverse to our business or operations.

Any future litigation against us could be costly and time-consuming to defend.

We may become subject, from time to time, to legal proceedings and claims that arise in the ordinary course of business such as claims brought by our clients in connection with commercial disputes or employment claims made by our current or former employees. Litigation might result in substantial costs and may divert management's attention and resources, which might seriously harm our business, overall financial condition, and operating results. Insurance might not cover such claims, might not provide sufficient payments to cover all the costs to resolve one or more such claims and might not continue to be available on terms acceptable to us. A claim brought against us that is uninsured or underinsured could result in unanticipated costs, thereby harming our operating results and leading analysts or potential investors to lower their expectations of our performance, which could reduce the trading price of our stock.

Any failure to protect our intellectual property rights could impair our ability to protect our proprietary technology and our brand.

Our success is dependent, in part, upon protecting our proprietary technology. We rely on a combination of copyrights, trademarks, service marks, trade secret laws and contractual restrictions to establish and protect our proprietary rights in our products and services. Our proprietary technologies are not covered by any patent or patent application. However, the steps we take to protect our intellectual property may be inadequate. We will not be able to protect our intellectual property if we are unable to enforce our rights or if we do not detect unauthorized use of our intellectual property. Despite our precautions, it may be possible for unauthorized third parties to copy our products and use information that we regard as proprietary to create products and services that compete with ours. Some license provisions protecting against unauthorized use, copying, transfer and disclosure of our products may be unenforceable under the laws of certain jurisdictions and foreign countries.

We enter into confidentiality and invention assignment agreements with our employees and consultants and enter into confidentiality agreements with the parties with whom we have strategic relationships and business alliances. No assurance can be given that these agreements will be effective in controlling access to and distribution of our products and proprietary information. The confidentiality agreements on which we rely to protect certain technologies may be

breached and may not be adequate to protect our proprietary technologies. Further, these agreements do not prevent our competitors from independently developing technologies that are substantially equivalent or superior to our solutions. In addition, we depend, in part, on technology of third parties licensed to us for our solutions, and the loss or inability to maintain these licenses or errors in the software we license could result in increased costs, reduced service levels or delayed sales of our solutions.

In order to protect our intellectual property rights, we may be required to spend significant resources to monitor and protect these rights. Litigation may be necessary in the future to enforce our intellectual property rights and to protect our trade secrets. Litigation brought to protect and enforce our intellectual property rights could be costly, time consuming and distracting to management and could result in the impairment or loss of portions of our intellectual property. Furthermore, our efforts to enforce our intellectual property rights may be met with defenses, counterclaims and countersuits attacking the validity and enforceability of our intellectual property rights. Our inability to protect our proprietary technology against unauthorized copying or use, as well as any costly litigation or diversion of our management's attention and resources, could delay further sales or the implementation of our solutions, impair the functionality of our solutions, delay introductions of new solutions, result in our substituting inferior or more costly technologies into our solutions, or injure our reputation. In addition, we may be required to license additional technology from third parties to develop and market new solutions, and we cannot assure you that we could license that technology on commercially reasonable terms, or at all. Although we do not expect that our inability to license this technology in the

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future would have a material adverse effect on our business or operating results, our inability to license this technology could adversely affect our ability to compete.

We may be sued by third parties for alleged infringement of their proprietary rights.

There is considerable patent and other intellectual property development activity in our industry. Our success depends, in part, upon our not infringing upon the intellectual property rights of others. Our competitors, as well as a number of other entities and individuals, may own or claim to own intellectual property relating to our industry. From time to time, third parties may claim that we are infringing upon their intellectual property rights, and we may be found to be infringing upon such rights. In the future, others may claim that our applications and underlying technology infringe or violate their intellectual property rights. However, we may be unaware of the intellectual property rights that others may claim cover some or all of our technology or services. Any claims or litigation could cause us to incur significant expenses and, if successfully asserted against us, could require that we pay substantial damages or ongoing royalty payments, prevent us from offering our services, or require that we comply with other unfavorable terms. We may also be obligated to indemnify our clients or business partners or pay substantial settlement costs, including royalty payments, in connection with any such claim or litigation and to obtain licenses, modify applications, or refund fees, which could be costly. Even if we were to prevail in such a dispute, any litigation regarding our intellectual property could be costly and time-consuming and divert the attention of our management and key personnel from our business operations.

The use of open source software in our products and solutions may expose us to additional risks and harm our intellectual property rights.

Some of our products and solutions use or incorporate software that is subject to one or more open source licenses. Open source software is typically freely accessible, usable and modifiable. Certain open source software licenses require a user who intends to distribute the open source software as a component of the user’s software to disclose publicly part or all of the source code to the user’s software. In addition, certain open source software licenses require the user of such software to make any derivative works of the open source code available to others on potentially unfavorable terms or at no cost.

The terms of many open source licenses to which we are subject have not been interpreted by U.S. or foreign courts. Accordingly, there is a risk that those licenses could be construed in a manner that imposes unanticipated conditions or restrictions on our ability to commercialize our solutions. In that event, we could be required to seek licenses from third parties in order to continue offering our products or solutions, to re-develop our products or solutions, to discontinue sales of our products or solutions, or to release our proprietary software code under the terms of an open source license, any of which could harm our business. Further, given the nature of open source software, it may be more likely that third parties might assert copyright and other intellectual property infringement claims against us based on our use of these open source software programs.

While we monitor the use of all open source software in our products, solutions, processes and technology and try to ensure that no open source software is used in such a way as to require us to disclose the source code to the related product or solution when we do not wish to do so, it is possible that such use may have inadvertently occurred in deploying our proprietary solutions. In addition, if a third-party software provider has incorporated certain types of open source software into software we license from such third party for our products and solutions without our knowledge, we could, under certain circumstances, be required to disclose the source code to our products and solutions. This could harm our intellectual property position and our business, results of operations and financial condition.

If third-party software used in our products is not adequately maintained or updated, our business could be materially adversely affected.

Our products utilize certain software of third-party software developers. For example, we license technology from bswift as part of our Paylocity Web Benefits solution. Although we believe that there are alternatives for these products, any significant interruption in the availability of such third-party software could have an adverse impact on our business unless and until we can replace the functionality provided by these products at a similar cost. Additionally, we rely, to a certain extent, upon such third parties' abilities to enhance their current products, to develop new products on a timely and cost-effective basis and to respond to emerging industry standards and other technological changes. We may

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be unable to replace the functionality provided by the third-party software currently offered in conjunction with our products in the event that such software becomes obsolete or incompatible with future versions of our products or is otherwise not adequately maintained or updated.

Changes in laws and regulations related to the Internet or changes in the Internet infrastructure itself may diminish the demand for our applications, and could have a negative impact on our business.

The future success of our business depends upon the continued use of the Internet as a primary medium for commerce, communication and business applications. Federal, state or foreign government bodies or agencies have in the past adopted, and may in the future adopt, laws or regulations affecting the use of the Internet as a commercial medium. Changes in these laws or regulations could require us to modify our applications in order to comply with these changes. In addition, government agencies or private organizations may begin to impose taxes, fees or other charges for accessing the Internet or commerce conducted via the Internet. These laws or charges could limit the growth of Internet-related commerce or communications generally, resulting in reductions in the demand for Internet-based applications such as ours.

In addition, the use of the Internet as a business tool could be adversely affected due to delays in the development or adoption of new standards and protocols to handle increased demands of Internet activity, security, reliability, cost, ease of use, accessibility, and quality of service. The performance of the Internet and its acceptance as a business tool has been adversely affected by “viruses,” “worms” and similar malicious programs, and the Internet has experienced a variety of outages and other delays as a result of damage to portions of its infrastructure. If the use of the Internet is adversely affected by these issues, demand for our applications could suffer.

Furthermore, the availability or performance of our applications could be adversely affected by a number of factors, including clients’ inability to access the Internet, the failure of our network or software systems, security breaches or variability in user traffic for our services. For example, our clients access our solutions through their Internet service providers. If a service provider fails to provide sufficient capacity to support our applications or otherwise experiences service outages, such failure could interrupt our clients’ access to our solutions, adversely affect their perception of our applications’ reliability and reduce our revenues. In addition to potential liability, if we experience interruptions in the availability of our applications, our reputation could be adversely affected and we could lose clients.

Regulatory requirements placed on our software and services could impose increased costs on us, delay or prevent our introduction of new products and services, and impair the function or value of our existing products and services.

Our products and services may become subject to increasing regulatory requirements, and as these requirements proliferate, we may be required to change or adapt our products and services to comply. Changing regulatory requirements might render our products and services obsolete or might block us from developing new products and

services. This might in turn impose additional costs upon us to comply or to further develop our products and services. It might also make introduction of new products and services more costly or more time-consuming than we currently anticipate. It might even prevent introduction by us of new products or services or cause the continuation of our existing products or services to become more costly.

We might require additional capital to support business growth, and this capital might not be available.

We intend to continue to make investments to support our business growth and might require additional funds to respond to business challenges or opportunities, including the need to develop new products and services or enhance our existing services, enhance our operating infrastructure, and acquire complementary businesses and technologies. Accordingly, we might need to engage in equity or debt financings to secure additional funds. In addition, we will need to expand our ACH capacity as we grow our business.

If we raise additional funds through further issuances of equity or convertible debt securities, our existing stockholders could suffer significant dilution, and any new equity securities we issue could have rights, preferences and privileges superior to those of holders of our common stock. Any debt financing or ACH facility secured by us in the future could involve restrictive covenants relating to our capital-raising activities and other financial and operational matters, which might make it more difficult for us to obtain additional capital and to pursue business opportunities and to grow our business. In addition, we might not be able to obtain additional financing on terms favorable to us, if at all. If

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we are unable to obtain adequate financing or financing on terms satisfactory to us when we require it, our ability to continue to support our business growth and to respond to business challenges could be significantly limited.

Our services present the potential for embezzlement, identity theft, or other similar illegal behavior by our associates with respect to third parties.

Certain services offered by us involve collecting payroll information from individuals, and this frequently includes information about their checking accounts. Our services also involve the use and disclosure of personal and business information that could be used to impersonate third parties, commit identity theft, or otherwise gain access to their data or funds. If any of our associates take, convert, or misuse such funds, documents or data, we could be liable for damages, and our business reputation could be damaged or destroyed. Moreover, if we fail to adequately prevent third parties from accessing personal and/or business information and using that information to commit identity theft, we might face legal liabilities and other losses than can have a negative impact on our business.

We rely on a third-party shipping provider to deliver printed checks to our clients, and therefore our business could be negatively impacted by disruptions in the operations of this third-party provider.

We rely on third-party couriers such as the United Parcel Service, or UPS, to ship printed checks to our clients. Relying on UPS and other third-party couriers puts us at risk from disruptions in their operations, such as employee strikes, inclement weather and their ability to perform tasks on our behalf. If UPS or other third-party couriers fail to perform their tasks, we could incur liability or suffer damages to our reputation, or both. If we are forced to use other third-party couriers, our costs could increase and we may not be able to meet shipment deadlines. Moreover, we may not be able to obtain terms as favorable as those we currently use, which could further increase our costs. These circumstances may negatively impact our business, financial condition and results of operations.

Our reported financial results may be adversely affected by changes in accounting principles generally accepted in the United States.

Generally accepted accounting principles in the United States are subject to interpretation by the Financial Accounting Standards Board, or FASB, the Securities and Exchange Commission, and various bodies formed to promulgate and interpret appropriate accounting principles. A change in these principles or interpretations could have a significant effect on our reported financial results including increased volatility, and could affect the reporting of transactions completed before the announcement of a change. Our accounting policies that have been or may be affected by changes in accounting principles include, but are not limited to, revenue recognition and accounting for leases.

We may acquire other companies or technologies, which could divert our management's attention, result in additional dilution to our stockholders and otherwise disrupt our operations and adversely affect our operating results.

We may in the future seek to acquire or invest in other businesses or technologies. The pursuit of potential acquisitions or investments may divert the attention of management and cause us to incur various expenses in identifying, investigating and pursuing suitable acquisitions, whether or not they are consummated.

In addition, we have limited experience in acquiring other businesses. If we acquire additional businesses, we may not be able to integrate the acquired personnel, operations and technologies successfully, or effectively manage the combined business following the acquisition. We also may not achieve the anticipated benefits from the acquired business due to a number of factors, including:

· Inability to integrate or benefit from acquired technologies or services in a profitable manner;

· Unanticipated costs or liabilities associated with the acquisition;

· Incurrence of acquisition-related costs;

· Difficulty integrating the accounting systems, operations and personnel of the acquired business;

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- Difficulties and additional expenses associated with supporting legacy products and hosting infrastructure of the acquired business;

- Difficulty converting the clients of the acquired business onto our applications and contract terms, including disparities in the revenues, licensing, support or professional services model of the acquired company;

- Diversion of management's attention from other business concerns;

- Adverse effects to our existing business relationships with business partners and clients as a result of the acquisition;

- The potential loss of key employees;

- Use of resources that are needed in other parts of our business; and

- Use of substantial portions of our available cash to consummate the acquisition.

In addition, a significant portion of the purchase price of companies we acquire may be allocated to acquired goodwill and other intangible assets, which must be assessed for impairment at least annually. In the future, if our acquisitions do not yield expected returns, we may be required to take charges to our operating results based on this impairment assessment process, which could adversely affect our results of operations.

Acquisitions could also result in dilutive issuances of equity securities or the incurrence of debt, which could adversely affect our operating results. In addition, if an acquired business fails to meet our expectations, our operating results, business and financial position may suffer.

Risks Related to Ownership of Our Common Stock

Insiders have substantial control over us, which may limit our stockholders' ability to influence corporate matters and delay or prevent a third party from acquiring control over us.

As of February 2, 2018, our directors, executive officers and holders of more than 5% of our common stock, together with their respective affiliates, beneficially owned, in the aggregate, approximately 42.2% of our outstanding common stock. This significant concentration of ownership may adversely affect the trading price for our common stock

because investors often perceive disadvantages in owning stock in companies with controlling stockholders. In addition, these stockholders will be able to exercise influence over all matters requiring stockholder approval, including the election of directors and approval of corporate transactions, such as a merger or other sale of our company or its assets. This concentration of ownership could limit the ability of our other stockholders to influence corporate matters and may have the effect of delaying or preventing a change in control, including a merger, consolidation, or other business combination involving us, or discouraging a potential acquirer from making a tender offer or otherwise attempting to obtain control, even if that change in control would benefit our other stockholders.

Our stock price may be subject to wide fluctuations.

The trading price of our common stock could be subject to wide fluctuations in response to various factors, some of which are beyond our control. These factors include those discussed in this "Risk Factors" section of this Quarterly Report on Form 10-Q and others such as:

- Our operating performance and the operating performance of similar companies;
- Announcements by us or our competitors of acquisitions, business plans or commercial relationships;
- Any major change in our board of directors or senior management;

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- Publication of research reports or news stories about us, our competitors, or our industry, or positive or negative recommendations or withdrawal of research coverage by securities analysts;

- The public's reaction to our press releases, our other public announcements and our filings with the SEC;

- Sales of our common stock by our directors, executive officers and affiliates;

- Adverse market reaction to any indebtedness we may incur or securities we may issue in the future;

- Short sales, hedging and other derivative transactions in our common stock;

- Threatened or actual litigation; and

- Other events or factors, including changes in general conditions in the United States and global economies or financial markets (including acts of God, war, incidents of terrorism, or other destabilizing events and the resulting responses to them).

In addition, the stock market in general and the market for Internet-related companies in particular, have experienced extreme price and volume fluctuations that have often been unrelated or disproportionate to the operating performance of those companies. Securities class action litigation has often been instituted against companies following periods of volatility in the overall market and in the market price of a company's securities. This litigation, if instituted against us, could result in substantial costs, divert our management's attention and resources, and harm our business, operating results, and financial condition.

We do not currently intend to pay dividends on our common stock and, consequently, your ability to achieve a return on your investment will depend on appreciation in the price of our common stock.

We have not declared or paid dividends on our common stock in the past three fiscal years and do not currently intend to do so for the foreseeable future. We currently intend to invest our future earnings, if any, to fund our growth. Therefore, you are not likely to receive any dividends on your common stock for the foreseeable future, and the success of an investment in shares of our common stock will depend upon future appreciation in its value, if any. There is no guarantee that shares of our common stock will appreciate in value or even maintain the price at which our stockholders purchased their shares.

Future sales of shares of our common stock by existing stockholders could depress the market price of our common stock.

As of February 2, 2018, we had an aggregate of 52,603,746 outstanding shares of common stock. The 17,362,750 shares sold in our initial public offering, follow-on offering and secondary offering can be freely sold in the public market without restriction. The remaining shares can be freely sold in the public market, subject in some cases to volume and other restrictions under Rule 144 and 701 under the Securities Act of 1933, as amended, and various agreements.

In addition, we have registered 15,092,927 shares of common stock that we have issued and may issue under our equity plans. These shares can be freely sold in the public market upon issuance, subject in some cases to volume and other restrictions under Rules 144 and 701 under the Securities Act, and various vesting agreements. In addition, some of our employees, including some of our executive officers, have entered into 10b5-1 trading plans regarding sales of shares of our common stock. These plans provide for sales to occur from time to time. If any of these additional shares are sold, or if it is perceived that they will be sold, in the public market, the trading price of our common stock could decline.

Also, in the future, we may issue additional securities in connection with investments and acquisitions. The amount of our common stock issued in connection with an investment or acquisition could constitute a material portion of our then outstanding stock. Due to these factors, sales of a substantial number of shares of our common stock in the

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public market could occur at any time. These sales, or the perception in the market that the holders of a large number of shares intend to sell shares, could reduce the market price of our common stock.

If we are unable to maintain effective internal controls over financial reporting, investors may lose confidence in the accuracy and completeness of our financial reports and the market price of our common stock may be negatively affected.

As a public company, we are required to maintain internal controls over financial reporting and to report any material weaknesses in such internal controls. Section 404 of the Sarbanes-Oxley Act of 2002, or the Sarbanes-Oxley Act, requires that we evaluate and determine the effectiveness of our internal controls over financial reporting and provide a management report on the internal controls over financial reporting. In addition, the Sarbanes-Oxley Act requires that our management report on the internal controls over financial reporting be attested to by our independent registered public accounting firm. If we have a material weakness in our internal controls over financial reporting, we may not detect errors on a timely basis and our financial statements may be materially misstated. Compliance with these public company requirements has made some activities more time-consuming, costly and complicated. If we identify material weaknesses in our internal controls over financial reporting, if we are unable to assert that our internal controls over financial reporting are effective, or if our independent registered public accounting firm is unable to express an opinion as to the effectiveness of our internal controls over financial reporting, investors may lose confidence in the accuracy and completeness of our financial reports and the market price of our common stock could be negatively affected, and we could become subject to investigations by the stock exchange on which our securities are listed, the SEC or other regulatory authorities, which could require additional financial and management resources.

We have incurred and will continue to incur significantly increased costs and devote substantial management time as a result of operating as a public company.

As a public company, we have incurred and will continue to incur significant legal, accounting and other expenses. For example, we are subject to the reporting requirements of the Securities Exchange Act of 1934, as amended, or the Exchange Act, and are required to comply with the applicable requirements of the Sarbanes-Oxley Act and the Dodd-Frank Wall Street Reform and Consumer Protection Act, as well as rules and regulations subsequently implemented by the SEC and the NASDAQ Global Select Market including the establishment and maintenance of effective disclosure and financial controls and changes in corporate governance practices. Compliance with these requirements has increased our legal and financial compliance costs and has made some activities more time consuming and costly. In addition, our management and other personnel have been required to divert attention from operational and other business matters to devote substantial time to these public company requirements. In particular, we have incurred and will continue to incur significant expenses as well as devote substantial management effort toward ensuring ongoing compliance with the requirements of Section 404 of the Sarbanes-Oxley Act. Although we have hired additional employees to comply with these requirements, we may need to hire additional accounting and financial staff with appropriate public company experience and technical accounting knowledge to comply with any regulatory changes.

If securities or industry analysts do not continue to publish research or publish unfavorable or misleading research about our business, our stock price and trading volume could decline.

The trading market for our common stock depends in part on the research and reports that securities or industry analysts publish about us or our business. If one or more of the analysts who covers us downgrades our stock or publishes unfavorable or misleading research about our business, our stock price would likely decline. If one or more of these analysts ceases coverage of our company or fails to publish reports on us regularly, we could lose visibility in the market for our stock and demand for our stock could decrease, which could cause our stock price or trading volume to decline.

Anti-takeover provisions in our charter documents and Delaware law could discourage, delay, or prevent a change in control of our company and may affect the trading price of our common stock.

We are a Delaware corporation and the anti-takeover provisions of the Delaware General Corporation Law, which apply to us, may discourage, delay or prevent a change in control by prohibiting us from engaging in a business combination with an interested stockholder for a period of three years after the stockholder becomes an interested stockholder, even if a change in control would be beneficial to our existing stockholders. In addition, our amended and

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restated certificate of incorporation and amended and restated bylaws may discourage, delay or prevent a change in our management or control over us that stockholders may consider favorable. Our amended and restated certificate of incorporation and bylaws:

- Authorize the issuance of "blank check" convertible preferred stock that could be issued by our board of directors to thwart a takeover attempt;

- Establish a classified board of directors, as a result of which the successors to the directors whose terms have expired will be elected to serve from the time of election and qualification until the third annual meeting following their election;

- Require that directors only be removed from office for cause and only upon a supermajority stockholder vote;

- Provide that vacancies on the board of directors, including newly-created directorships, may be filled only by a majority vote of directors then in office rather than by stockholders;

- Prevent stockholders from calling special meetings; and

- Prohibit stockholder action by written consent, requiring all actions to be taken at a meeting of the stockholders.

Our bylaws provide that the state and federal courts located within the state of Delaware are the sole and exclusive forums for certain legal actions involving the company or our directors, officers and employees.

On February 2, 2016, we amended our bylaws to designate the state and federal courts located within the state of Delaware as the sole and exclusive forums for claims arising derivatively, pursuant to the Delaware General Corporation Law or governed by the internal affairs doctrine. The choice of forum provision is expressly authorized by the Delaware General Corporation Law, which was amended so that companies would not have to litigate internal claims in more than one jurisdiction. If a court were to find the exclusive forum provision contained in our bylaws to be inapplicable or unenforceable, we may incur additional costs associated with resolving such extra-forum claims, which could adversely affect our business and financial condition. This bylaw provision, therefore, may dissuade or discourage claimants from initiating lawsuits or claims against us or our directors and officers in forums other than Delaware.

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

(a) Sales of Unregistered Securities

Not applicable.

(b) Use of Proceeds

On March 24, 2014, we completed our initial public offering or IPO, of 8,101,750 shares of common stock, at a price of $17.00 per share, before underwriting discounts and commissions. The offer and sale of all of the shares in the IPO were registered under the Securities Act pursuant to a registration statement on Form S-1 (File No. 333-193661), which was declared effective by the SEC on March 18, 2014. With the proceeds of the IPO, we repaid amounts outstanding under a note issued by us to Commerce Bank & Trust Company on March 9, 2011, which totaled $1.1 million, paid $9.4 million for the purchase of substantially all of the assets of BFKMS Inc. and paid $9.5 million for the purchase of substantially all of the assets of Synergy Payroll, LLC.

On December 17, 2014, we completed a follow-on offering of 4,960,000 shares of common stock at a price of $26.25 per share, before underwriting discounts and commissions. The offer and sale of all of the shares in the follow-on offering were registered under the Securities Act pursuant to a registration statement on Form S-1 (File No. 333-200448) which was declared effective by the SEC on December 11, 2014. There have been no material changes in the planned use of proceeds from the follow-on as described in the final prospectus filed with the SEC pursuant to Rule 424(b) on December 12, 2014.

On September 30, 2015, we completed a secondary offering of 4,301,000 shares of common stock at a price of $29.75 per share, before underwriting discounts and commissions. The offer and sale of all of the shares in the secondary

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offering were registered under the Securities Act pursuant to a registration statement on Form S-3 (File No. 333-206941) which was declared effective by the SEC on September 25, 2015. The Company did not receive any proceeds from the sale of common stock, as all the shares were sold by shareholders of the Company.

Item 3. Defaults upon Senior Securities

None.

Item 4. Mine Safety Disclosures

Not applicable.

Item 5. Other Information

None.

Item 6. Exhibits

The information required by this Item is set forth in the Index to Exhibits immediately following this page.

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INDEX TO EXHIBITS

Exhibit Nos.	Description
3.1	First Amended and Restated Certificate of Incorporation (filed as Exhibit 3.2 of Paylocity Holding Corporation's Form S-1 Registration Statement (Registration No. 333-193661).
3.2	Amended and Restated Bylaws of Paylocity Holding Corporation (filed as Exhibit 3.2 of Paylocity Holding Corporation's Annual Report on Form 10-K for the year ended June 30, 2017 (File No. 001-36348)).
31.1*	Certification of Chief Executive Officer pursuant to Securities Exchange Act Rules 13a-4 and 15d-14 as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2*	Certification of Chief Financial Officer pursuant to Securities Exchange Act Rules 13a-4 and 15d-14 as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1**	Certification pursuant to 18 U.S.C. 1350, adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, by Chief Executive Officer.
32.2**	Certification pursuant to 18 U.S.C. 1350, adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, by Chief Financial Officer.
101.INS*	XBRL Instance Document.
101.SCH*	XBRL Taxonomy Extension Schema Document.
101.CAL*	XBRL Taxonomy Extension Calculation Linkbase Document.
101.DEF*	XBRL Taxonomy Extension Definition Linkbase Document.
101.LAB*	XBRL Taxonomy Extension Label Linkbase Document.
101.PRE*	XBRL Taxonomy Extension Presentation Linkbase Document.

* Filed herewith

** Furnished herewith

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SIGNATURES

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

PAYLOCITY HOLDING CORPORATION

Date: February 9, 2018 By: /S/ Steven R. Beauchamp
Name: Steven R. Beauchamp
Title: Chief Executive Officer

Date: February 9, 2018 By: /S/ Toby J. Williams
Name: Toby J. Williams
Title: Chief Financial Officer (Principal Financial Officer)