Paylocity Holding Corp
Form 10-Q
May 06, 2016
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, DC 20549

Form 10-Q

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

For the quarterly period ended March 31, 2016

o **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 x No o

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 x No o

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

Large Accelerated Filer	o	Accelerated Filer	x
Non-Accelerated Filer	o (Do not check if a smaller reporting company)	Smaller Reporting Company	o

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

Indicate the number of shares outstanding of each of the issuer s classes of common stock, as of the latest practicable date: 51,010,873 shares of Common Stock, $0.001 par value per share, as of April 29, 2016.

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Paylocity Holding Corporation

Form 10-Q

For the Quarterly Period Ended March 31, 2016

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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, 2015	March 31, 2016
Assets		
Current assets:		
Cash and cash equivalents	$ 81,258	$ 89,707
Accounts receivable, net	1,115	1,725
Prepaid expenses and other	4,416	7,059
Deferred income tax assets, net	775	387
Total current assets before funds held for clients	87,564	98,878
Funds held for clients	591,219	1,422,976
Total current assets	678,783	1,521,854
Long-term prepaid expenses	403	856
Capitalized internal-use software, net	7,357	10,181
Property and equipment, net	16,061	24,934
Intangible assets, net	11,941	10,799
Goodwill	6,003	6,003
Total assets	$ 720,548	$ 1,574,627
Liabilities and Stockholders Equity		
Current liabilities:		
Accounts payable	$ 1,327	$ 851
Consideration related to acquisitions	511	
Accrued expenses	16,430	24,964
Total current liabilities before client fund obligations	18,268	25,815
Client fund obligations	591,219	1,422,976
Total current liabilities	609,487	1,448,791
Deferred rent	2,607	4,643

Deferred income tax liabilities, net		874		599
Total liabilities	$	612,968	$	1,454,033
Stockholders equity:				
Preferred stock, $0.001 par value, 5,000 authorized, no shares issued and outstanding at June 30, 2015 and March 31, 2016	$		$	
Common stock, $0.001 par value, 155,000 shares authorized at June 30, 2015 and March 31, 2016; 50,703 shares issued and outstanding at June 30, 2015 and 50,984 shares issued and outstanding at March 31, 2016		51		51
Additional paid-in capital		155,672		167,125
Accumulated deficit		(48,143)		(46,582)
Total stockholders equity	$	107,580	$	120,594
Total liabilities and stockholders equity	$	720,548	$	1,574,627

See accompanying notes to unaudited consolidated financial statements.

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PAYLOCITY HOLDING CORPORATION

Unaudited Consolidated Statements of Operations

(in thousands, except per share data)

	Three months ended March 31, 2015	Three months ended March 31, 2016	Nine months ended March 31, 2015	Nine months ended March 31, 2016
Revenues:				
Recurring fees	$ 43,335	$ 66,279	$ 104,532	$ 160,374
Interest income on funds held for clients	601	803	1,354	1,946
Total recurring revenues	43,936	67,082	105,886	162,320
Implementation services and other	3,336	3,488	6,808	8,542
Total revenues	47,272	70,570	112,694	170,862
Cost of revenues:				
Recurring revenues	12,606	18,576	34,616	47,858
Implementation services and other	6,676	8,633	18,164	23,646
Total cost of revenues	19,282	27,209	52,780	71,504
Gross profit	27,990	43,361	59,914	99,358
Operating expenses:				
Sales and marketing	12,673	17,681	31,152	44,471
Research and development	5,053	6,759	14,351	18,987
General and administrative	8,559	12,720	24,068	34,410
Total operating expenses	26,285	37,160	69,571	97,868
Operating income (loss)	1,705	6,201	(9,657)	1,490
Other income (expense)	51	(83)	180	214
Income (loss) before income taxes	1,756	6,118	(9,477)	1,704
Income tax benefit (expense)	(4)	43	(66)	(143)
Net income (loss)	$ 1,752	$ 6,161	$ (9,543)	$ 1,561
Net income (loss) per share:				
Basic	$ 0.03	$ 0.12	$ (0.19)	$ 0.03
Diluted	$ 0.03	$ 0.12	$ (0.19)	$ 0.03
Weighted-average shares used in computing net income (loss) per share:				
Basic	50,533	50,962	49,954	50,865
Diluted	52,203	53,424	49,954	53,431

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 Capital	Accumulated Deficit	Total Stockholders Equity
	Shares	Amount			
Balances at June 30, 2015	50,703	$ 51	$ 155,672	$ (48,143)	$ 107,580
Stock-based compensation expense			14,035		14,035
Stock options exercised	311		2,773		2,773
Issuance of common stock upon vesting of restricted stock units	108				
Issuance of common stock under employee stock purchase plan	50		1,403		1,403
Net settlement for taxes and/or exercise price related to equity awards	(188)		(6,758)		(6,758)
Net income				1,561	1,561
Balances at March 31, 2016	50,984	$ 51	$ 167,125	$ (46,582)	$ 120,594

See accompanying notes to the unaudited consolidated financial statements.

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PAYLOCITY HOLDING CORPORATION

Unaudited Consolidated Statements of Cash Flows

(in thousands)

	Nine Months Ended March 31, 2015	Nine Months Ended March 31, 2016
Cash flows from operating activities:		
Net income (loss)	$ (9,543)	$ 1,561
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Stock-based compensation	10,672	13,212
Depreciation and amortization	6,245	9,875
Deferred income tax expense	59	113
Provision for doubtful accounts	89	90
Loss on disposal of equipment	45	301
Changes in operating assets and liabilities:		
Accounts receivable	(403)	(700)
Prepaid expenses	(2,042)	(3,069)
Trade accounts payable	359	(606)
Accrued expenses	4,720	8,290
Net cash provided by (used in) operating activities	10,201	29,067
Cash flows from investing activities:		
Capitalized internal-use software costs	(2,544)	(5,807)
Purchases of property and equipment	(6,331)	(11,746)
Payments for acquisitions	(2,985)	(483)
Net change in funds held for clients	(314,355)	(831,757)
Net cash provided by (used in) investing activities	(326,215)	(849,793)
Cash flows from financing activities:		
Net change in client funds obligation	314,355	831,757
Proceeds from follow-on offering, net of cash paid for issuance costs	18,367	
Payments on initial public offering costs	(75)	
Proceeds from exercise of stock options	247	137
Proceeds from employee stock purchase plan	670	1,403
Taxes paid related to net share settlement of equity awards	(3,171)	(4,122)
Net cash provided by (used in) financing activities	330,393	829,175
Net Change in Cash and Cash Equivalents	14,379	8,449
Cash and Cash Equivalents Beginning of Period	78,848	81,258
Cash and Cash Equivalents End of Period	$ 93,227	$ 89,707
Supplemental Disclosure of Non-Cash Investing and Financing Activities		
Build-out allowance received from landlords	$ 253	$ 1,888
Purchase of property and equipment and internal-use software, accrued but not paid	$ 701	$ 683
Supplemental disclosure of cash flow information		
Cash paid for income taxes, net of refunds	$ 28	$ 20

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.

Secondary Offering

In September 2015, the Company completed a secondary offering in which its existing shareholders sold 3,740 shares of common stock at a public offering price of $29.75 per share. The Company did not receive any proceeds from the sale of common stock by the existing shareholders.

In October 2015, the underwriters for the Company s secondary offering exercised their option to purchase 561 additional shares from certain shareholders of the Company as described in the final prospectus filed with the Securities and Exchange Commission (SEC) on September 25, 2015. The Company did not receive any proceeds from the sale of common stock by the existing shareholders.

(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, stock-based compensation, valuation of net deferred income tax assets 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 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 results of operations, financial position, changes in stockholders equity and cash flows. The results of operations for the three and nine months ended March 31, 2016 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, 2015 included in the Company s Annual Report on Form 10-K filed with the SEC on August 14, 2015.

(c) ***Income Taxes***

Differences in the normal relationship between the income tax benefit (expense) and pre-tax income (loss) materially result from the existence of a valuation allowance recorded against the preponderance of the net deferred tax assets.

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(d) ***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.

(e) ***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, 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) to amend certain guidance in ASU 2014-09. These amendments are intended to improve the operability and understandability of the implementation guidance on principal versus agent considerations. 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 is currently assessing the potential effects of these changes to its consolidated financial statements and is evaluating the adoption method and timing.

In November 2015, the FASB issued ASU 2015-17, *Balance Sheet Classification of Deferred Taxes* (Topic 740) (ASU 2015-17). ASU 2015-17 requires all deferred income tax assets and liabilities to be classified as non-current in a classified balance sheet. This ASU would first apply prospectively or retrospectively for fiscal years beginning after December 15, 2016. Earlier adoption is permitted as of the beginning of an interim or annual reporting period. The Company is currently assessing the potential effects of these changes to its consolidated financial statements and is evaluating the adoption method and timing.

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 is evaluating the timing of adoption.

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 is currently assessing the potential effects of these changes to its consolidated financial statements and is evaluating the timing of adoption.

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

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(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, 2015	$	149
Charged to expense		90
Write-offs		(46)
Balance at March 31, 2016	$	193

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

		June 30, 2015		**March 31, 2016**
Capitalized internal-use software	$	24,733	$	31,426
Accumulated amortization		(17,376)		(21,245)
Capitalized internal-use software, net	$	7,357	$	10,181

Amortization of capitalized internal-use software costs is included in Cost of Revenues-Recurring Revenues and amounted to $643 and $1,504 for the three months ended March 31, 2015 and 2016, respectively and $1,921 and $3,869 for the nine months ended March 31, 2015 and 2016, respectively.

Property and equipment consist of the following:

		June 30, 2015		**March 31, 2016**
Office equipment	$	1,875	$	2,475
Computer equipment		11,783		16,486
Furniture and fixtures		2,423		3,954
Software		5,218		5,112
Leasehold improvements		6,639		10,465
Time clocks rented by clients		3,217		3,914
		31,155		42,406
Accumulated depreciation		(15,094)		(17,472)
Property and equipment, net	$	16,061	$	24,934

Depreciation expense amounted to $1,252 and $1,835 for the three months ended March 31, 2015 and 2016, respectively and $3,754 and $4,864 for the nine months ended March 31, 2015 and 2016, respectively.

Intangible assets consist of the following:

	June 30, 2015	March 31, 2016	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	(999)	(2,141)	
Intangible assets, net	$ 11,941	$ 10,799	

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Amortization expense for acquired intangible assets was $190 and $381 for the three months ended March 31, 2015 and 2016, respectively and $570 and $1,142 for the nine months ended March 31, 2015 and 2016, respectively. Future amortization expense for acquired intangible assets is as follows, as of March 31, 2016:

Remainder of fiscal 2016	$	381
Fiscal 2017		1,512
Fiscal 2018		1,427
Fiscal 2019		1,398
Fiscal 2020		1,398
Thereafter		4,683
Total	$	10,799

The components of accrued expenses were as follows:

		June 30, 2015		March 31, 2016
Accrued payroll and personnel costs	$	14,275	$	21,020
Current portion of deferred rent		727		367
Other		1,428		3,577
Total accrued expenses	$	16,430	$	24,964

(4) 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.

Substantially all of the Company s assets that are measured at fair value on a recurring basis are measured using Level 1 inputs. The Company considers the recorded value of its financial assets and liabilities, which consist primarily of cash and cash equivalents, accounts receivable, and accounts payable, to approximate the fair value of the respective assets and liabilities at June 30, 2015 and March 31, 2016 based upon the short-term nature of the assets and liabilities.

(5) 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

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of directors. The Company s board of directors determined that, effective January 1, 2016, it would increase the number of common shares in reserve for issuance under the 2014 Plan by 2,293 shares.

As of March 31, 2016, the Company had 10,810 shares allocated to the plans, of which 4,676 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 our equity incentive plans during the nine months ended March 31, 2016:

	Number of Shares
Available for grant at July 1, 2015	4,490
January 1, 2016 Evergreen provision	2,293
RSUs granted	(732)
Options granted	(149)
Shares withheld in settlement of taxes and exercise price	188
Forfeitures	128
Shares removed	(84)
Available for grant at March 31, 2016	6,134

Shares removed represents forfeitures of shares and shares withheld in settlement of taxes and 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:

	Three months ended March 31,		Nine months ended March 31,	
	2015	2016	2015	2016
Cost of revenue recurring	$ 431	$ 451	$ 1,245	$ 1,256
Cost of revenue non-recurring	354	301	1,031	875
Sales and marketing	861	1,195	2,639	3,313
Research and development	717	756	2,101	2,140
General and administrative	1,172	2,017	3,656	5,628
Total stock-based compensation expense	$ 3,535	$ 4,720	$ 10,672	$ 13,212

In addition, the Company capitalized $180 and $281 of stock-based compensation expense in its internal-use software in the three months ended March 31, 2015 and 2016, respectively and $490 and $823 in the nine months ended March 31, 2015 and 2016, 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 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.

The Company values stock options using the Black-Scholes option-pricing model, which requires the input of subjective assumptions, including the risk-free rate, expected life, expected stock price volatility and dividend yield. The risk-free interest rate assumption is based upon observed interest rates for U.S. Treasury securities consistent with the expected term of the Company s employee stock options. The expected life represents the period of time the stock options are expected to be outstanding and is based on the simplified method. Under the simplified method, the expected life of an option is presumed to be the mid-point between the vesting date and the end of the contractual term. As the Company has a limited history of trading as a public company, the Company utilizes the simplified method due to the lack of sufficient historical exercise data to provide a reasonable basis upon which to otherwise estimate the expected life of the stock options. Therefore, the expected volatility is based on historical volatilities for publicly traded stock of comparable companies over the estimated expected life of the stock options. The Company assumed no dividend yield because it does not expect to pay dividends in the near future, which is consistent with the Company s history of not paying dividends.

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The following table summarizes the assumptions used for estimating the fair value of stock options granted for the nine months ended March 31:

	Period ended March 31, 2015	2016
Valuation assumptions:		
Expected dividend yield	0%	0%
Expected volatility	43.9%	34.0%
Expected term (years)	6.25	6.25
Risk-free interest rate	1.91%	1.83%

The table below presents stock option activity during the nine months ended March 31, 2016:

	Outstanding Options			
	Number of shares	Weighted average exercise price	Weighted average remaining contractual term	Aggregate intrinsic value
Balance at July 1, 2015	3,956	$ 10.96	7.63	$ 98,434
Options granted	149	35.28		
Options forfeited	(96)	16.39		
Options exercised	(311)	8.93		
Balance at March 31, 2016	3,698	$ 11.97	7.00	$ 77,154
Options exercisable at March 31, 2016	2,342	$ 9.10	6.51	$ 55,365
Options vested and expected to vest at March 31, 2016	3,627	$ 11.80	6.97	$ 76,297

There were no options granted during either of the three months ended March 31, 2015 and 2016. The weighted average grant date fair value of options granted during the nine months ended March 31, 2015 and 2016 was $11.15 and $12.92, respectively. The total intrinsic value of options exercised was $5,054 and $908 during the three-month periods ended March 31, 2015 and 2016, respectively and $7,117 and $8,496 during the nine-month periods ended March 31, 2015 and 2016, respectively. At March 31, 2016, there was $3,589 of total unrecognized compensation cost, net of estimated forfeitures, related to unvested stock option granted under the Plan. That cost is expected to be recognized over a weighted average period of 1.58 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 three or four years following the grant date. Certain RSU awards have time-based vesting conditions while other RSU awards are based on attainment of certain performance benchmarks. The following table represents restricted stock unit activity during the nine months ended March 31, 2016:

	Units	Weighted average grant date fair value
RSU balance at July 1, 2015	386	$ 24.98
RSUs granted	732	35.23

RSUs vested	(108)		25.51
RSUs cancelled/forfeited	(32)		30.46
RSU balance at March 31, 2016	978	$	32.45
RSUs expected to vest at March 31, 2016	862	$	32.28

At March 31, 2016, there was $17,416 of total unrecognized compensation cost, net of estimated forfeitures, related to unvested restricted stock awards granted under the Plan. That cost is expected to be recognized over a weighted average period of 2.19 years.

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(b) ***Employee Stock Purchase Plan***

The Company s 2014 Employee Stock Purchase Plan (ESPP) was adopted by the Company s board of directors and approved by the stockholders on February 6, 2014 and was effective upon completion of the Company s initial public offering.

Under the Company s 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.

As of March 31, 2016, a total of 1,003 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. For fiscal year 2016, the Company s board of directors determined that it would not increase the number of common shares reserved for issuance under the ESPP.

The Company issued 50 shares upon the completion of its six-month offering period ending November 15, 2015. The Company recorded compensation expense attributable to the ESPP of $176 and $283 for the three months ended March 31, 2015 and 2016, respectively and $460 and $791 for the nine months ended March 31, 2015 and 2016, respectively, which is included in the summary of stock-based compensation expense above. The grant date fair value of the ESPP offering periods during the nine months ended March 31 was estimated using the following weighted average assumptions:

	Period ended March 31,	
	2015	**2016**
Valuation assumptions:		
Expected dividend yield	0%	0%
Expected volatility	35.5 41.7%	44.1 - 48.4%
Expected term (years)	0.3 0.5	0.5
Risk-free interest rate	0.04 0.06%	0.11 - 0.31%

(c) ***401(k) Plan***

The Company maintains a 401(k) plan with a safe harbor matching provision that covers all eligible employees. Up to December 31, 2015, the Company matched 50% of the employees contributions up to 6% of their gross pay. Effective January 1, 2016, the Company increased its match to 50% of employees contributions up to 8% of their gross pay. Contributions were $474 and $821 for the three-month periods ended March 31, 2015 and 2016, respectively and were $1,183 and $1,937 for the nine-month periods ended March 31, 2015 and 2016, respectively.

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(6) 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 and are reflected in diluted earnings per share by application of the treasury stock method. The following table presents the calculation of basic and diluted net income (loss) per share:

	Three months ended March 31,		Nine months ended March 31,	
	2015	2016	2015	2016
Numerator:				
Net income (loss)	$ 1,752	$ 6,161	$ (9,543)	$ 1,561
Denominator:				
Weighted-average shares used in computing net income (loss) per share:				
Basic	50,533	50,962	49,954	50,865
Weighted-average effect of potentially dilutive shares:				
Employee stock options, restricted stock units and employee stock purchase plan shares	1,670	2,462		2,566
Diluted	52,203	53,424	49,954	53,431
Net income (loss) per share:				
Basic	$ 0.03	$ 0.12	$ (0.19)	$ 0.03
Diluted	$ 0.03	$ 0.12	$ (0.19)	$ 0.03

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 March 31,		Nine months ended March 31,	
	2015	2016	2015	2016
Employee stock options	328	147	4,111	147
Restricted stock units	6	11	370	655
Employee stock purchase plan shares			36	
Total	334	158	4,517	802

(7) Income Taxes

The Company s quarterly provision for income taxes is based on an estimated annual income tax rate. 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 benefit (expense) of $(4) and $43 for the three-month periods ended March 31, 2015 and 2016, respectively and $(66) and $(143) for the nine-month periods ended March 31, 2015 and 2016, respectively. The Company s effective tax rate for the three and nine months ended March 31, 2015 and 2016 differs 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 2015 and for the nine months ending March 31, 2016. As of March 31, 2016, the Company had no unrecognized tax benefits.

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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 further, including declines in 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 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.

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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 $105.9 million for the nine months ended March 31, 2015 to $162.3 million for the nine months ended March 31, 2016, representing a 53% year-over-year increase. Recurring revenue represented 94% and 95% of total revenue during the nine month periods ended March 31, 2015 and 2016, respectively. Recurring revenue increased from $43.9 million for the three months ended March 31, 2015 to $67.1 million for the three months ended March 31, 2016, representing a 53% year-over-year increase. Recurring revenue represented 93% and 95% of total revenue during the three month periods ended March 31, 2015 and 2016, respectively.

Recurring Fees from New Clients

We calculate 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 recurring fees from new clients was 47% and 48% for the three months ended March 31, 2015 and 2016, respectively, and 42% and 43% for the nine months ended March 31, 2015 and 2016, 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 it 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 (loss) 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 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, depreciation and amortization, stock-based compensation expense, and employer payroll taxes related to stock releases and option exercises. The table below sets forth our Adjusted Gross Profit, Adjusted Recurring Gross Profit and Adjusted EBITDA for the periods presented.

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	Three months ended March 31, 2015		Three months ended March 31, 2016		Nine months ended March 31, 2015		Nine months ended March 31, 2016
	(in thousands)				(in thousands)		
Adjusted Gross profit	$	29,435	$	45,627	$	64,130	$ 105,449
Adjusted Recurring Gross Profit	$	32,415	$	50,469	$	74,447	$ 119,648
Adjusted EBITDA	$	7,526	$	14,612	$	7,651	$ 25,139

	Three months ended March 31, 2015	Three months ended March 31, 2016	Nine months ended March 31, 2015	Nine months ended March 31, 2016
	(in thousands)		(in thousands)	
Reconciliation from Gross Profit to Adjusted Gross Profit				
Gross profit	$ 27,990	$ 43,361	$ 59,914	$ 99,358
Amortization of capitalized internal-use software costs	643	1,504	1,921	3,869
Stock-based compensation expense and employer payroll taxes related to stock releases and option exercises	802	762	2,295	2,222
Adjusted Gross Profit	$ 29,435	$ 45,627	$ 64,130	$ 105,449

	Three months ended March 31, 2015	Three months ended March 31, 2016	Nine months ended March 31, 2015	Nine months ended March 31, 2016
	(in thousands)		(in thousands)	
Reconciliation from Total Recurring Revenues to Adjusted Recurring Gross Profit				
Total recurring revenues	$ 43,936	$ 67,082	$ 105,886	$ 162,320
Cost of recurring revenues	12,606	18,576	34,616	47,858
Recurring gross profit	31,330	48,506	71,270	114,462
Amortization of capitalized internal-use software costs	643	1,504	1,921	3,869
Stock-based compensation expense and employer payroll taxes related to stock releases and option exercises	442	459	1,256	1,317
Adjusted Recurring Gross Profit	$ 32,415	$ 50,469	$ 74,447	$ 119,648

	Three months ended March 31, 2015	Three months ended March 31, 2016	Nine months ended March 31, 2015	Nine months ended March 31, 2016
	(in thousands)		(in thousands)	
Reconciliation from Net Income (Loss) to Adjusted EBITDA				
Net income (loss)	$ 1,752	$ 6,161	$ (9,543)	$ 1,561
Income tax (benefit) expense	4	(43)	66	143
Depreciation and amortization	2,085	3,720	6,245	9,875
EBITDA	3,841	9,838	(3,232)	11,579
	3,685	4,774	10,883	13,560

Stock-based compensation expense and employer payroll taxes related to stock releases and option exercises								
Adjusted EBITDA	$	7,526	$	14,612	$	7,651	$	25,139

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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 clients have consistently had on average between 95 and 115 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 in respect of 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 92% and 94% of our total revenues during the three months ended March 31, 2015 and 2016, respectively, and 93% and 94% of our total revenues during the nine month periods ended March 31, 2015 and 2016, respectively.

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 financial institutions with which we have automated clearing house, or ACH, arrangements.

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

Costs of recurring revenues are generally expensed as incurred, and include 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 third-party reseller costs, delivery costs, computing costs and amortization of capitalized internal-use software 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 $0.6 million and $1.5 million during the three months ended March 31, 2015 and 2016, respectively, and $1.9 million and $3.9 million during the nine months ended March 31, 2015 and 2016, respectively.

Cost of Implementation Services and Other

Cost of implementation services and other consists almost entirely 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 expanding our client base, and doing so will require increased personnel to implement our

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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, typically by running its first payroll. 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, benefits and bonuses. 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 nine months ended March 31, 2015 and 2016.

	Three months ended March 31,		Nine months ended March 31,	
	2015	**2016**	**2015**	**2016**
Capitalized portion of research and development	$ 1,145	$ 2,376	$ 3,034	$ 6,693
Expensed portion of research and development	5,053	6,759	14,351	18,987
Total research and development	$ 6,198	$ 9,135	$ 17,385	$ 25,680

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 other employee-related costs, including wages, benefits, stock-based compensation and bonuses for our administrative, finance, accounting, and human resources departments. Additional expenses include consulting and professional fees, insurance and other corporate expenses.

We expect our general and administrative expenses to continue to increase in absolute dollars as a result of our operation as a public company. These expenses will also include costs associated with compliance with regulations governing public companies, costs of directors and officers liability insurance and professional services expenses.

Other Income (Expense)

Other income (expense) generally consists of interest income related to interest received on our cash and cash equivalents and disposals of property and equipment.

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Results of Operations

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

	Three months ended March 31, 2015	Three months ended March 31, 2016	Nine months ended March 31, 2015	Nine months ended March 31, 2016
	(in thousands)		(in thousands)	
Consolidated Statements of Operations Data:				
Revenues:				
Recurring fees	$ 43,335	$ 66,279	$ 104,532	$ 160,374
Interest income on funds held for clients	601	803	1,354	1,946
Total recurring revenues	43,936	67,082	105,886	162,320
Implementation services and other	3,336	3,488	6,808	8,542
Total revenues	47,272	70,570	112,694	170,862
Cost of revenues:				
Recurring revenues	12,606	18,576	34,616	47,858
Implementation services and other	6,676	8,633	18,164	23,646
Total cost of revenues	19,282	27,209	52,780	71,504
Gross profit	27,990	43,361	59,914	99,358
Operating expenses:				
Sales and marketing	12,673	17,681	31,152	44,471
Research and development	5,053	6,759	14,351	18,987
General and administrative	8,559	12,720	24,068	34,410
Total operating expenses	26,285	37,160	69,571	97,868
Operating income (loss)	1,705	6,201	(9,657)	1,490
Other income (expense)	51	(83)	180	214
Income (loss) before income taxes	1,756	6,118	(9,477)	1,704
Income tax benefit (expense)	(4)	43	(66)	(143)
Net income (loss)	$ 1,752	$ 6,161	$ (9,543)	$ 1,561

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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 March 31, 2015	Three months ended March 31, 2016	Nine months ended March 31, 2015	Nine months ended March 31, 2016
	(in thousands)		(in thousands)	
Consolidated Statements of Operations Data:				
Revenues:				
Recurring fees	92%	94%	93%	94%
Interest income on funds held for clients	1%	1%	1%	1%
Total recurring revenues	93%	95%	94%	95%
Implementation services and other	7%	5%	6%	5%
Total revenues	100%	100%	100%	100%
Cost of revenues:				
Recurring revenues	27%	26%	31%	28%
Implementation services and other	14%	12%	16%	14%
Total cost of revenues	41%	38%	47%	42%
Gross profit	59%	62%	53%	58%
Operating expenses:				
Sales and marketing	26%	25%	27%	26%
Research and development	11%	10%	13%	11%
General and administrative	18%	18%	21%	20%
Total operating expenses	55%	53%	61%	57%
Operating income (loss)	4%	9%	(8)%	1%
Other income (expense)	0%	0%	0%	0%
Income (loss) before income taxes	4%	9%	(8)%	1%
Income tax benefit (expense)	0%	0%	0%	0%
Net income (loss)	4%	9%	(8)%	1%

Comparison of Three Months Ended March 31, 2015 and 2016

Revenues

	Three Months Ended March 31, 2015	Three Months Ended March 31, 2016	Change $	Change %
Recurring fees	$ 43,335	$ 66,279	$ 22,944	53%
Percentage of total revenues	92%	94%		
Interest income on funds held for clients	601	803	202	34%
Percentage of total revenues	1%	1%		
Implementation services and other	3,336	3,488	152	5%
Percentage of total revenues	7%	5%		

Recurring Fees

Recurring fees for the three months ended March 31, 2016 increased by $22.9 million, or 53%, to $66.3 million from $43.3 million for the three months ended March 31, 2015. Recurring fees increased primarily as a result of incremental revenues from new and existing clients, including revenue related to our Affordable Care Act (ACA) compliance solution offered to new and existing clients.

Interest Income on Funds Held for Clients

Interest income on funds held for clients for the three months ended March 31, 2016 increased by $0.2 million, or 34% to $0.8 million from $0.6 million for the three months ended March 31, 2015. Interest income on funds held for clients increased primarily as a result of an increased average daily balance for funds held due to the addition of new clients to our client base.

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Implementation Services and Other

Implementation services and other revenue for the three months ended March 31, 2016 increased by $0.2 million, or 5%, to $3.5 million from $3.3 million for the three months ended March 31, 2015. Implementation services and other revenue increased primarily as a result of an increase in the number of new clients during the three months ended March 31, 2016 in comparison to the three months ended March 31, 2015.

Cost of Revenues

	Three Months Ended March 31,		Change	
	2015	**2016**	**$**	**%**
Cost of recurring revenues	$ 12,606	$ 18,576	$ 5,970	47%
Percentage of recurring revenues	29%	28%		
Recurring gross margin	71%	72%		
Cost of implementation services and other	6,676	8,633	1,957	29%
Percentage of implementation services and other revenue	200%	248%		
Implementation gross margin	(100)%	(148)%		

Cost of Recurring Revenues

Cost of recurring revenues for the three months ended March 31, 2016 increased by $6.0 million, or 47%, to $18.6 million from $12.6 million for the three months ended March 31, 2015. Cost of recurring revenues increased primarily as a result of the continued growth of our business, in particular $3.3 million in employee-related costs resulting from additional personnel necessary to provide services to new and existing clients, $2.7 million in fees related to the delivery of our services and $0.9 million in increased internal-use software amortization, partially offset by a $0.9 million decrease in reseller expenses primarily due to our acquisition of our remaining reseller during fiscal 2015. Recurring gross margin increased from 71% for the three months ended March 31, 2015 to 72% for the three months ended March 31, 2016, primarily due to a reduction in reseller expenses, partially offset by an increase in internal-use software amortization and employee-related costs.

Cost of Implementation Services and Other

Cost of implementation services and other for the three months ended March 31, 2016 increased by $2.0 million, or 29%, to $8.6 million from $6.7 million for the three months ended March 31, 2015. Cost of implementation services and other increased primarily due to an increase of $2.1 million in employee-related and other costs to implement our solutions for new and existing clients during the three months ended March 31, 2016.

Operating Expenses

Sales and Marketing

	Three Months Ended March 31,		Change	
	2015	**2016**	**$**	**%**
Sales and marketing	$ 12,673	$ 17,681	$ 5,008	40%
Percentage of total revenues	26%	25%		

Sales and marketing expenses for the three months ended March 31, 2016 increased by $5.0 million, or 40%, to $17.7 million from $12.7 million for the three months ended March 31, 2015. The increase in sales and marketing expenses was primarily the result of $4.1 million of additional employee-related expenses incurred due to the expansion of our sales force by 60 personnel (including management, sales engineers, direct sales and sales administration), our sales lead generation group by 27 personnel and our marketing team by 5 personnel.

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Research and Development

	Three Months Ended March 31,		Change	
	2015	**2016**	**$**	**%**
Research and development	$ 5,053	$ 6,759	$ 1,706	34%
Percentage of total revenues	11%	10%		

Research and development for the three months ended March 31, 2016 increased by $1.7 million, or 34%, to $6.8 million from $5.1 million for the three months ended March 31, 2015. The increase in research and development expense was primarily as a result of $2.5 million in employee-related expenses related to 54 additional development personnel, partially offset by higher year-over-year internal-use software capitalization of $1.1 million.

General and Administrative

	Three Months Ended March 31,		Change	
	2015	**2016**	**$**	**%**
General and administrative	$ 8,559	$ 12,720	$ 4,161	49