

Benefitfocus, Inc.  
Form 10-Q  
November 07, 2014  
**Table of Contents**

**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**  
**Washington, D.C. 20549**

**FORM 10-Q**

(Mark One)

☒ **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

**For the quarterly period ended September 30, 2014**

**or**

☐ **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

**For the transition period from \_\_\_\_\_ to \_\_\_\_\_.**

**Commission File Number: 001-36061**

**Benefitfocus, Inc.**

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

<b>Delaware</b> <b>(State or other jurisdiction of</b>	<b>46-2346314</b> <b>(I.R.S. Employer</b>
<b>incorporation or organization)</b>	<b>Identification No.)</b>
<b>100 Benefitfocus Way</b>	
<b>Charleston, South Carolina 29492</b>	
<b>(Address of principal executive offices and zip code)</b>	
<b>(843) 849-7476</b>	
<b>(Registrant's telephone number, including area code)</b>	

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 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 ☐

Edgar Filing: Benefitfocus, Inc. - Form 10-Q

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

Large accelerated filer ☐

Accelerated filer ☐

Non-accelerated filer ☒ (Do not check if a smaller reporting company)

Smaller reporting company ☐

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

As of November 5, 2014, there were approximately 25,555,551 shares of the registrant's common stock outstanding.

**Table of Contents**

**Benefitfocus, Inc.**

**Form 10-Q**

**For the Quarterly Period Ended September 30, 2014**

**TABLE OF CONTENTS**

**PART I. FINANCIAL INFORMATION**

<b><u>ITEM 1. FINANCIAL STATEMENTS</u></b>	<b>2</b>
<b><u>Unaudited Consolidated Balance Sheets as of September 30, 2014 and December 31, 2013</u></b>	<b>2</b>
<b><u>Unaudited Consolidated Statements of Operations and Comprehensive Loss for the Three and Nine Months ended September 30, 2014 and 2013</u></b>	<b>3</b>
<b><u>Unaudited Consolidated Statements of Changes in Stockholders' (Deficit) Equity for the Nine Months ended September 30, 2014</u></b>	<b>4</b>
<b><u>Unaudited Consolidated Statements of Cash Flows for the Nine Months ended September 30, 2014 and 2013</u></b>	<b>5</b>
<b><u>Notes to Unaudited Consolidated Financial Statements</u></b>	<b>6</b>
<b><u>ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS</u></b>	<b>14</b>
<b><u>ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK</u></b>	<b>27</b>
<b><u>ITEM 4. CONTROLS AND PROCEDURES</u></b>	<b>28</b>

**PART II. OTHER INFORMATION**

<b><u>ITEM 1A. RISK FACTORS</u></b>	<b>29</b>
<b><u>ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS</u></b>	<b>45</b>
<b><u>ITEM 6. EXHIBITS</u></b>	<b>46</b>
<b><u>SIGNATURES</u></b>	<b>47</b>

[Table of Contents](#)**PART I. FINANCIAL INFORMATION****ITEM 1. FINANCIAL STATEMENTS****Benefitfocus, Inc.****Unaudited Consolidated Balance Sheets***(in thousands, except share and per share data)*

	As of September 30, 2014	As of December 31, 2013
<b>Assets</b>		
Current assets:		
Cash and cash equivalents	\$ 53,776	\$ 65,645
Marketable securities	7,131	13,168
Accounts receivable, net	17,962	23,668
Prepaid expenses and other current assets	4,691	4,322
Total current assets	83,560	106,803
Property and equipment, net	43,546	27,444
Intangible assets, net	1,027	1,256
Goodwill	1,634	1,634
Other non-current assets	1,928	2,474
Total assets	\$ 131,695	\$ 139,611
<b>Liabilities and stockholders (deficit) equity</b>		
Current liabilities:		
Accounts payable	\$ 3,236	\$ 4,354
Accrued expenses	5,784	3,911
Accrued compensation and benefits	18,265	14,183
Deferred revenue, current portion	18,076	15,158
Financing and capital lease obligations, current portion	4,010	4,288
Total current liabilities	49,371	41,894
Deferred revenue, net of current portion	73,326	65,063
Revolving line of credit	12,757	5,757
Financing and capital lease obligations, net of current portion	25,210	14,263
Other non-current liabilities	2,189	1,202
Total liabilities	162,853	128,179

## Commitments and contingencies

## Stockholders' (deficit) equity:

Preferred stock, par value \$0.001, 5,000,000 shares authorized, no shares issued and outstanding at September 30, 2014 and December 31, 2013

Common stock, par value \$0.001, 50,000,000 shares authorized, 25,552,595 and 24,495,651 shares issued and outstanding at September 30, 2014 and December 31, 2013, respectively

	26	24
Additional paid-in capital	221,385	214,487
Accumulated deficit	(252,569)	(203,079)

Total stockholders' (deficit) equity	(31,158)	11,432
--------------------------------------	----------	--------

Total liabilities and stockholders' (deficit) equity	\$ 131,695	\$ 139,611
--	------------	------------

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

**Table of Contents****Benefitfocus, Inc.****Unaudited Consolidated Statements of Operations and Comprehensive Loss***(in thousands, except share and per share data)*

	<b>Three Months Ended September 30,</b>		<b>Nine Months Ended September 30,</b>	
	<b>2014</b>	<b>2013</b>	<b>2014</b>	<b>2013</b>
Revenue	\$ 34,200	\$ 26,317	\$ 97,233	\$ 74,496
Cost of revenue	23,355	16,171	63,618	42,938
Gross profit	10,845	10,146	33,615	31,558
Operating expenses:				
Sales and marketing	12,105	7,354	37,159	27,096
Research and development	11,469	6,527	30,619	16,824
General and administrative	5,033	2,623	12,834	8,184
Change in fair value of contingent consideration				(43)
Total operating expenses	28,607	16,504	80,612	52,061
Loss from operations	(17,762)	(6,358)	(46,997)	(20,503)
Other income (expense):				
Interest income	14	8	64	31
Interest expense	(1,141)	(554)	(2,526)	(1,597)
Other (expense) income	(8)	9	(11)	(29)
Total other expense, net	(1,135)	(537)	(2,473)	(1,595)
Loss before income taxes	(18,897)	(6,895)	(49,470)	(22,098)
Income tax (benefit) expense	(9)	(59)	20	(19)
Net loss	\$ (18,888)	\$ (6,836)	\$ (49,490)	\$ (22,079)
Comprehensive loss	\$ (18,888)	\$ (6,836)	\$ (49,490)	\$ (22,079)
Net loss per common share:				
Basic and diluted	\$ (0.74)	\$ (1.08)	\$ (1.97)	\$ (4.15)
Weighted-average common shares outstanding:				
Basic and diluted	25,503,194	6,320,731	25,085,072	5,315,008

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





**Table of Contents****Benefitfocus, Inc.****Unaudited Consolidated Statements of Changes in Stockholders (Deficit) Equity***(in thousands, except share data)*

	<b>Common Stock, \$0.001 Par Value Shares</b>	<b>Par Value</b>	<b>Additional Paid-in Capital</b>	<b>Accumulated Deficit</b>	<b>Total Stockholders (Deficit) Equity</b>
Balance, December 31, 2013	24,495,651	\$ 24	\$ 214,487	\$ (203,079)	\$ 11,432
Exercise of stock options	600,330	1	2,705		2,706
Issuance of common stock upon vesting of restricted stock units, net of shares surrendered for taxes	1,093		(19)		(19)
Issuance of common stock for cashless exercise of warrant	455,521	1	(1)		
Stock-based compensation expense			3,544		3,544
Accretion of customer warrant			669		669
Net loss				(49,490)	(49,490)
Balance, September 30, 2014	25,552,595	\$ 26	\$ 221,385	\$ (252,569)	\$ (31,158)

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

**Table of Contents****Benefitfocus, Inc.****Unaudited Consolidated Statements of Cash Flows***(in thousands)*

	<b>Nine Months Ended September 30,</b>	
	<b>2014</b>	<b>2013</b>
<b>Cash flows from operating activities</b>		
Net loss	\$ (49,490)	\$ (22,079)
Adjustments to reconcile net loss to net cash and cash equivalents (used in) provided by operating activities:		
Depreciation and amortization	7,600	5,926
Stock-based compensation expense	3,544	821
Change in fair value and accretion of warrant	669	669
Interest accrual on financing obligation	2,050	1,325
Change in fair value of contingent consideration		(18)
Provision for doubtful accounts	5	55
Loss on disposal or impairment of property and equipment	15	20
Changes in operating assets and liabilities:		
Accounts receivable, net	5,701	(7,860)
Accrued interest on short-term investments	166	
Prepaid expenses and other current assets	234	(1,012)
Other non-current assets	546	
Accounts payable	(1,323)	3,871
Accrued expenses	1,353	766
Accrued compensation and benefits	4,082	6,076
Deferred revenue	11,181	14,838
Other non-current liabilities	987	234
Net cash and cash equivalents (used in) provided by operating activities	(12,680)	3,632
<b>Cash flows from investing activities</b>		
Purchases of short-term investments held to maturity	(12,959)	
Proceeds from maturity of short-term investments held to maturity	18,830	
Purchases of property and equipment	(7,985)	(6,695)
Proceeds from sale of property and equipment		9
Net cash and cash equivalents used in investing activities	(2,114)	(6,686)
<b>Cash flows from financing activities</b>		
Proceeds from initial public offering, net of issuance costs		70,064
Draws on revolving line of credit	7,000	10,757

Payments on revolving line of credit	(5,000)	
Proceeds from notes payable borrowing	1,465	
Repayment of notes payable	(7,447)	
Proceeds from exercises of stock options	2,706	572
Proceeds from issuance of common stock (excluding IPO)		68
Remittance of taxes upon vesting of restricted stock units	(19)	
Payments on financing and capital lease obligations	(6,762)	(2,456)
Net cash and cash equivalents provided by financing activities	2,925	68,023
<b>Net (decrease) increase in cash and cash equivalents</b>	<b>(11,869)</b>	<b>64,969</b>
Cash and cash equivalents, beginning of period	65,645	19,703
<b>Cash and cash equivalents, end of period</b>	<b>\$ 53,776</b>	<b>\$ 84,672</b>
<b>Supplemental disclosure of non-cash investing and financing activities</b>		
Property and equipment acquisitions in accounts payable and accrued expenses	\$ 726	\$
Property and equipment acquired with financing and capital lease obligations	\$ 14,777	\$ 1,138
Post contract support acquired with financing obligations	\$ 604	\$

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

**Table of Contents**

**BENEFITFOCUS, INC.**

**NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS**

**(dollars in thousands, except share and per share data)**

**1. Organization and Description of Business**

Benefitfocus, Inc. (the Company) is a leading provider of cloud-based benefits software solutions for consumers, employers, insurance carriers and brokers delivered under a software-as-a-service (SaaS) model. The financial statements of the Company include the financial position and operations of its wholly owned subsidiaries, Benefitfocus.com, Inc., Benefit Informatics, Inc. and BenefitStore, Inc.

**2. Summary of Significant Accounting Policies**

***Principles of Consolidation***

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

***Interim Unaudited Consolidated Financial Information***

The accompanying unaudited consolidated financial statements and footnotes have been prepared in accordance with GAAP as contained in the Financial Accounting Standards Board (FASB) Accounting Standards Codification (the Codification or ASC) for interim financial information, and with Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by GAAP for complete financial statements. In the opinion of management, the interim financial information includes all adjustments of a normal recurring nature necessary for a fair presentation of the results of operations, financial position, changes in stockholders' equity and cash flows. The results of operations for the three- and nine-month periods ended September 30, 2014 are not necessarily indicative of the results for the full year or the results for any other future period. These unaudited consolidated financial statements should be read in conjunction with the audited financial statements and related footnotes for the year ended December 31, 2013 included in the Company's annual report on Form 10-K.

***Use of Estimates***

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

***Concentrations of Credit Risk***

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

To manage accounts receivable risk, the Company evaluates the creditworthiness of its customers and maintains an allowance for doubtful accounts. Accounts receivable were unsecured and were derived from revenue earned from customers located in the United States. Accounts receivable from one customer, Aetna, represented 10.9% and 11.3%, of the total accounts receivable at September 30, 2014 and December 31, 2013, respectively. No customer represented more than 10% of total revenue for the three- and nine- month periods ended September 30, 2014 and 2013.

**Table of Contents*****Accounts Receivable and Allowance for Doubtful Accounts and Returns***

Accounts receivable is stated at realizable value, net of allowances for doubtful accounts and returns. The Company utilizes the allowance method to provide for doubtful accounts based on management's evaluation of the collectability of amounts due and other relevant factors. Bad debt expense is recorded in general and administrative expense on the unaudited consolidated statements of operations and comprehensive loss. The Company bases its estimate on historical collection experience and a review of the current status of accounts receivable. Historically, actual write-offs for uncollectible accounts have not significantly differed from the Company's estimates. The Company removes recorded receivables and the associated allowances when they are deemed permanently uncollectible. However, higher than expected bad debts could result in write-offs that are greater than the Company's estimates. The allowance for doubtful accounts was \$15 and \$10 as of September 30, 2014 and December 31, 2013, respectively.

The allowances for returns are accounted for as reductions of revenue and are estimated based on the Company's periodic assessment of historical experience and trends. The Company considers factors such as the time lag since the initiation of revenue recognition, historical reasons for adjustments, new customer volume, complexity of billing arrangements, timing of software availability, and past due customer billings. The allowance for returns was \$1,095 and \$800 as of September 30, 2014 and December 31, 2013, respectively.

***Capitalized Software Development Costs***

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

In the three months ended September 30, 2014 and 2013, the Company capitalized software development costs of \$562 and \$971, and amortized capitalized software development costs of \$751 and \$662, respectively. In the nine months ended September 30, 2014 and 2013, the Company capitalized software development costs of \$1,499 and \$2,350, and amortized capitalized software development costs of \$2,214 and \$1,904, respectively. The net book value of capitalized software development costs was \$3,455 and \$4,170 at September 30, 2014 and December 31, 2013, respectively.

***Comprehensive Loss***

The Company's net loss equals comprehensive loss for all periods presented, as the Company has no components of other comprehensive income (loss).

***Recently Adopted Accounting Pronouncements***

In July 2013, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2013-11, Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists. ASU 2013-11 allows an unrecognized tax benefit, or a portion of an unrecognized tax benefit, to be presented in the financial statements as a reduction to a deferred tax asset for a net operating loss carryforward, a similar tax loss, or a tax credit carryforward, with one exception. That exception states

that, to the extent a net operating loss carryforward, a similar tax loss, or a tax credit carryforward is not available at the reporting date under the tax law of the applicable jurisdiction to settle any additional income taxes that would result from the disallowance of a tax position or the tax law of the applicable jurisdiction does not require the entity to use, and the entity does not intend to use, the deferred tax asset for such purpose, the unrecognized tax benefit should be presented in the financial statements as a liability and should not be combined with deferred tax assets. The assessment of whether a deferred tax asset is available is based on the unrecognized tax benefit and deferred tax asset that exist at the reporting date and should be made presuming disallowance of the tax position at the reporting date. ASU 2013-11 is effective for fiscal years, and interim periods within those years, beginning after December 15, 2013. The adoption of this guidance did not have an impact on the Company's consolidated financial statements.

**Table of Contents**

In May 2014, the FASB issued ASU No. 2014-09 Revenue from Contracts with Customers, which amends the revenue recognition requirements in the FASB Accounting Standards Codification (ASC). This statement requires that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. The statement shall be applied using one of two methods: retrospectively to each prior reporting period presented, or retrospectively with the cumulative effect of initially applying this statement recognized at the date of initial application. The Company has not yet determined which method it will apply. This statement is effective for annual reporting periods beginning after December 15, 2016, including interim periods within that reporting period. Early adoption is not permitted. The Company is currently evaluating the impact of this guidance on the Company's consolidated financial position and results of operations.

**3. Net Loss Per Common Share**

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

	<b>Three Months Ended September 30,</b>		<b>Nine Months Ended September 30,</b>	
<b>Anti-Dilutive Common Share Equivalents</b>	<b>2014</b>	<b>2013</b>	<b>2014</b>	<b>2013</b>
Restricted stock units	476,719		476,719	
Stock options	2,428,341	3,117,177	2,428,341	3,117,177
Warrant to purchase common stock		500,000		500,000
Total anti-dilutive common share equivalents	2,905,060	3,617,177	2,905,060	3,617,177

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

	<b>Three Months Ended September 30,</b>		<b>Nine Months Ended September 30,</b>	
	<b>2014</b>	<b>2013</b>	<b>2014</b>	<b>2013</b>
<b>Numerator:</b>				
Net loss	\$ (18,888)	\$ (6,836)	\$ (49,490)	\$ (22,079)
Net loss attributable to common stockholders	\$ (18,888)	\$ (6,836)	\$ (49,490)	\$ (22,079)
<b>Denominator:</b>				
Weighted-average common shares outstanding, basic and diluted	25,503,194	6,320,731	25,085,072	5,315,008
Net loss per common share, basic and diluted	\$ (0.74)	\$ (1.08)	\$ (1.97)	\$ (4.15)



#### 4. Fair Value Measurement

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

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

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

**Table of Contents*****Assets and Liabilities Measured at Fair Value on a Recurring Basis***

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

The following tables present information about the Company's assets and liabilities that are measured at fair value on a recurring basis using the above categories, as of September 30, 2014 and December 31, 2013.

<b>Description</b>	<b>September 30, 2014</b>			<b>Total</b>
	<b>Level 1</b>	<b>Level 2</b>	<b>Level 3</b>	
Cash equivalents:				
Money market mutual funds (1)	\$ 53,699	\$	\$	\$ 53,699
<b>Total assets</b>	<b>\$ 53,699</b>	<b>\$</b>	<b>\$</b>	<b>\$ 53,699</b>

<b>Description</b>	<b>December 31, 2013</b>			<b>Total</b>
	<b>Level 1</b>	<b>Level 2</b>	<b>Level 3</b>	
Cash equivalents:				
Money market mutual funds (1)	\$ 65,443	\$	\$	\$ 65,443
<b>Total assets</b>	<b>\$ 65,443</b>	<b>\$</b>	<b>\$</b>	<b>\$ 65,443</b>

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

***Assets Measured at Fair Value on a Recurring Basis Using Significant Unobservable Inputs (Level 3)***

The following table presents the changes in the Company's Level 3 instruments measured at fair value on a recurring basis for the three- and nine-month periods ended September 30, 2013 (no such assets in 2014):

	<b>Three Months Ended September 30, 2013</b>	<b>Nine Months Ended September 30, 2013</b>
Balance of contingent consideration at beginning of period	\$ 304	\$ 328
Change in fair value		(43)
Accretion of discount	6	25

Balance of contingent consideration at end of period	\$	310	\$	310
---	----	-----	----	-----

## 5. Marketable Securities

Marketable securities consist of corporate bonds and are classified as held-to-maturity. The amortized cost basis and net carrying amount of marketable securities was \$7,131 and \$13,168 and the aggregate fair value was \$7,127 and \$13,166, as of September 30, 2014 and December 31, 2013, respectively. The gross unrealized holding gains were \$0 and \$0 and the gross unrealized losses were \$4 and \$2, as of September 30, 2014 and December 31, 2013, respectively. Corporate bonds held in marketable securities had contractual maturities of between 1 and 6 months as of September 30, 2014.

**Table of Contents**

The following table presents information about the Company's investments that were in an unrealized loss position and for which an other-than-temporary impairment has not been recognized in earnings as of:

	September 30, 2014	December 31, 2013
Aggregate fair value of investments with unrealized losses (1)	\$ 5,131	\$ 1,281
Aggregate amount of unrealized losses	(4)	(2)

(1) Investments have been in a continuous loss position for less than 12 months

**6. Revolving Line of Credit and Notes Payable**

In August 2014, the borrowing limit under the Company's line of credit increased from \$15,000 to \$35,000 in accordance with the terms of the agreement. Borrowing capacity under the line of credit is subject to a borrowing base limit that is a function of the Company's monthly recurring revenue as adjusted to reflect lost customer revenue during the previous quarter.

In June 2014, the Company borrowed \$7,000 under its line of credit, which was used to fund the general operations of the Company. As of September 30, 2014, the amount outstanding under this line of credit was \$12,757 and the amount available to borrow, adjusted by the borrowing base limit, was \$17,407.

**7. Commitments and Contingencies*****Operating Lease Commitments***

In September 2014, the Company entered into an amendment to its operating lease for office space in Greenville, South Carolina. The amendment expands the space leased, extends the term of the lease for five years to February 2020, and grants the Company the right to extend the lease for five additional one-year periods. Monthly lease payments under the amended lease will begin February 2015. Expenses under this lease will total approximately \$95 per quarter.

In May 2014, the Company entered into a sublease for additional office space in North Charleston, South Carolina. The lease commenced June 1, 2014 and continues until January 31, 2018. The terms of lease contain a rent concession of four months. Expenses related to this lease total approximately \$52 per quarter.

In February 2013, the Company entered into an amendment to a 2009 operating lease for additional office space. The lease commenced January 1, 2014 and expenses for the additional space total \$236 per quarter.

***Financing and Capital Lease Obligations***

In April 2014, the Company recorded a capital lease for data processing equipment and software. The total payments under the lease are \$3,779, including a down payment of \$1,340 and aggregate monthly payments of \$2,439. The lease provides for a bargain purchase option at the end of its three-year term.

Related to the April 2014 capital lease, the Company recorded a financing obligation for support services for data processing equipment. Total payments under this three-year arrangement are \$629, including a down payment of \$223 and aggregate monthly payments of \$406.

In December 2013, the Company entered into a 15 year build-to-suit lease for additional office space to expand its headquarters campus. The leased premises are being constructed and the Company is involved extensively in the construction of the premises. The Company is deemed the owner for accounting purposes during the construction period and is required to capitalize the project costs during the construction period on its Consolidated Balance Sheets. The Company has recorded construction in process of \$11,352 and \$167, and a financing obligation of \$12,092 and \$202, as of September 30, 2014 and December 31, 2013, respectively.

**Table of Contents****8. Stock-based Compensation*****Restricted Stock Units***

During July 2014, the Company granted 89,746 Restricted Stock Units (RSUs) to employees with an aggregate grant date fair value of \$4,259. These RSUs vest in equal annual installments generally over 4 years from the grant date. The Company amortizes the fair value of the stock subject to the RSUs at the time of grant on a straight-line basis over the period of vesting. The Company recognizes the income tax benefits resulting from vesting of RSUs in the period they vest, to the extent the compensation expense has been recognized.

In June 2014, the Board of Directors of the Company established a compensation program for the Company's independent directors. Each independent director will receive an annual retainer of \$150, payable at the director's election either 50% in cash and 50% in RSUs, or 100% in RSUs. The RSUs vest on the first anniversary of the Company's annual stockholders meeting held in the year of the grant, or, if earlier, immediately prior to the subsequent year's annual stockholders meeting. Pursuant to this program, the Company granted four directors RSUs for an aggregate of 44,282 shares of common stock. Aggregate grant date fair value of these awards is \$1,564. Estimated remaining expense in the amounts of \$186, \$587, \$462, and \$211 will be recognized in 2014, 2015, 2016, and 2017, respectively, as General and Administrative expense.

During April 2014, the Company granted 264,359 RSUs to employees with an aggregate grant date fair value of \$12,663. These RSUs vest in equal annual installments, generally over 4 years from the grant date. The fair value of the stock subject to the RSUs at the time of grant is amortized based on a straight-line basis over the period of vesting. Income tax benefits resulting from vesting of RSUs are recognized in the period the units are vested and exchanged for common stock to the extent the compensation expense has been recognized.

***Warrants***

During 2009, in connection with a new five-year contract executed with a major customer, the Company issued a warrant to the customer for the right to purchase 500,000 shares of common stock at \$5.48 per share. The warrant was issued from the stock option pool of shares approved by the Board of Directors. The warrant had a term of 10 years. The customer was originally entitled to exercise the warrant in its entirety in 9.5 years, with earlier exercise rights under certain conditions. The original terms of the warrant also provided that, in the event the customer cancelled the contract prior to the end of its five-year term, one-half of the warrant would be forfeited. In March 2013, the Company accelerated the vesting of the warrant, making it fully exercisable. As a result of the modification, quarterly remeasurement of the warrant was no longer required. For the three and nine months ended September 30, 2014 and 2013, the reduction to revenue related to the warrant was \$223 and \$669, respectively, in each year.

On March 28, 2014, the customer exercised the warrant through a cashless exercise in accordance with the warrant's terms. The Company issued 455,521 shares to satisfy its obligation under the warrant.

**9. Income Taxes**

The Company's effective federal tax rate for the three and nine months ended September 30, 2014 was less than one percent, primarily as a result of estimated tax losses for the fiscal year offset by the increase in the valuation allowance on the net operating loss carryforwards. Current tax (benefit) expense relates to estimated state income taxes.

**10. Segments and Geographic Information**

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

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

**Table of Contents**

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

	<b>Three Months Ended September 30,</b>		<b>Nine Months Ended September 30,</b>	
	<b>2014</b>	<b>2013</b>	<b>2014</b>	<b>2013</b>
Revenue:				
Employer	\$ 14,937	\$ 9,823	\$ 42,503	\$ 27,417
Carrier	19,263	16,494	54,730	47,079
Total revenue	\$ 34,200	\$ 26,317	\$ 97,233	\$ 74,496
Depreciation and amortization by segment:				
Employer	\$ 1,307	\$ 710	\$ 3,453	\$ 2,123
Carrier	1,293	1,331	4,147	3,803
Total depreciation and amortization	\$ 2,600	\$ 2,041	\$ 7,600	\$ 5,926
(Loss) Income from operations:				
Employer	\$ (14,899)	\$ (6,879)	\$ (40,658)	\$ (18,923)
Carrier	(2,863)	521	(6,339)	(1,580)
Total operating loss	\$ (17,762)	\$ (6,358)	\$ (46,997)	\$ (20,503)

Substantially all assets were held and all revenue was generated in the United States during the three and nine months ended September 30, 2014 and 2013.

**11. Related Parties*****Related Party Leasing Arrangements***

The Company leases its headquarters building under the terms of a non-cancelable financing obligation from a build-to-suit lease and its additional office space in Charleston, South Carolina under the terms of a non-cancelable operating lease from an entity with which two of the Company's directors, significant stockholders, and executives are affiliated. Both the financing obligation and the lease have 15-year terms which started in 2006 and 2009, respectively. The Company has an option to renew the financing obligation and lease for five additional years. The arrangement provides for 3.0% fixed annual rent increases. Payments under these agreements were \$1,109 and \$876 for the three months ended September 30, 2014 and 2013, respectively and \$3,560 and \$2,839 for the nine months ended September 30, 2014 and 2013, respectively. Amounts due to the related parties were \$295 and \$268 as of September 30, 2014 and December 31, 2013, respectively. Amounts due to the related parties were recorded as Accrued expenses as of September 30, 2014 and Accounts payable as of December 31, 2013.



Payments for the amendment to the 2009 operating lease commenced on January 1, 2014, and expenses total \$236 per quarter.

***Related Party Travel Expenses***

The Company utilizes the services of a private air transportation company that is owned and controlled by one of the Company's directors, significant stockholders, and executives. Expenses related to this company were \$138 and \$87 for the three months ended September 30, 2014 and 2013, respectively and \$342 and \$242 for the nine months ended September 30, 2014 and 2013, respectively. Amounts due to this related party were \$59 and \$25 as of September 30, 2014 and December 31, 2013, respectively and were recorded in Accrued expenses as of September 30, 2014 and December 31, 2013.

**12. Subsequent Events**

***Restricted Stock Units***

During October 2014, the Company granted 281,500 RSUs to employees with an aggregate grant date fair value of \$7,335. These RSUs vest in equal annual installments generally over 4 years from the grant date. The Company amortizes the fair value of the stock subject to the RSUs at the time of grant on a straight-line basis over the period of vesting. The Company recognizes the income tax benefits resulting from vesting of RSUs in the period they vest, to the extent the compensation expense has been recognized.

**Table of Contents**

**SPECIAL NOTE REGARDING FORWARD-LOOKING STATEMENTS**

This Quarterly Report on Form 10-Q contains forward-looking statements that involve risks and uncertainties, as well as assumptions that, if they never materialize or prove incorrect, could cause our results to differ materially from those expressed or implied by such forward-looking statements. The statements contained in this Quarterly Report on Form 10-Q that are not purely historical are forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, or Securities Act, and Section 21E of the Securities Exchange Act of 1934, as amended, or Exchange Act. Such forward-looking statements include any expectation of earnings, revenue or other financial items; any statements of the plans, strategies and objectives of management for future operations; factors that may affect our operating results; statements about our ability to establish and maintain intellectual property rights; statements about our ability to retain and hire necessary associates and appropriately staff our operations; statements related to future capital expenditures; statements related to future economic conditions or performance; statements as to industry trends; and other matters that do not relate strictly to historical facts or statements of assumptions underlying any of the foregoing. Forward-looking statements are often identified by the use of words such as, but not limited to, anticipate, believe, can, continue, could, estimate, expect, intend, may, might, will, plan, would, and similar expressions or variations intended to identify forward-looking statements. These statements are based on the beliefs and assumptions of our management based on information currently available to management. Such forward-looking statements are subject to risks, uncertainties and other important factors that could cause actual results and the timing of certain events to differ materially from future results expressed or implied by such forward-looking statements. Factors that could cause or contribute to such differences include, but are not limited to, those discussed in the section titled Risk Factors included in Item 1A of Part II of this Quarterly Report on Form 10-Q, and the risks discussed in our other SEC filings. Furthermore, such forward-looking statements speak only as of the date of this report. Except as required by law, we undertake no obligation to update any forward-looking statements to reflect events or circumstances after the date of such statements.

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

## **Table of Contents**

### **ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

*The following discussion and analysis of our financial condition and results of operations should be read in conjunction with our consolidated financial statements and related notes appearing elsewhere in this Quarterly Report on Form 10-Q and with the financial statements, related notes and Management's Discussion and Analysis of Financial Condition and Results of Operations in our annual report on Form 10-K for the fiscal year ended December 31, 2013. The following discussion contains forward-looking statements that reflect our plans, estimates and beliefs. Our actual results could differ materially from those discussed in the forward-looking statements. Factors that could cause or contribute to such differences include, but are not limited to, those discussed in the section titled "Risk Factors" included in Item 1A of Part II of this Quarterly Report on Form 10-Q, and the risks discussed in our other SEC filings.*

#### **Overview**

We are a leading provider of cloud-based benefits software solutions for consumers, employers, insurance carriers, and brokers. The Benefitfocus platform provides an integrated suite of solutions that enables our employer and insurance carrier customers to more efficiently shop, enroll, manage, and exchange benefits information. Our web-based platform has a user-friendly interface designed to enable the insured consumers to access all of their benefits in one place. Our comprehensive solutions support core benefits plans, including healthcare, dental, life, and disability insurance, and voluntary benefits plans, such as critical illness, supplemental income, and wellness programs. As the number of employer benefits plans has increased, with each plan subject to many different business rules and requirements, demand for the Benefitfocus platform has grown.

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

We sell our software solutions and related services primarily through our direct sales force. We derive most of our revenue from software services fees, which primarily consist of monthly subscription fees paid to us for access to and usage of our cloud-based benefits software solutions, and related professional services. Software services fees paid to us from our employer customers are generally based on the number of employees covered by the relevant benefits plans at contracted rates for a specified period of time, which is usually one year. Software services fees paid to us from our carrier customers are based on the number of members contracted to use our solutions at contracted rates for a specified period of time, which usually ranges from three to five years. Our carrier contracts are generally only cancellable by the carrier in an instance of our uncured breach, although some of our carrier customers are able to terminate their respective contracts without cause or for convenience. Software services revenue accounted for approximately 90% and 93% of our total revenue during the three months ended September 30, 2014 and 2013, respectively, and approximately 92% and 93% of our total revenue during the nine months ended September 30, 2014

and 2013, respectively.

Another component of our revenue is professional services. We derive the majority of our professional services revenue from the implementation of our customers onto our platform, which typically includes discovery, configuration and deployment, integration, testing, and training. In general, it takes four to five months to implement a new employer customer's benefits systems and eight to 10 months to implement a new carrier customer's benefits systems. We also provide customer support services and customized media content that supports our customers' effort to educate and communicate with consumers. Professional services revenue accounted for approximately 10% and 7% of our total revenue during the three months ended September 30, 2014 and 2013, respectively, and approximately 8% and 7% of our total revenue during the nine months ended September 30, 2014 and 2013, respectively.

Increasing our base of large employer customers is an important source of revenue growth for us. We actively pursue new employer customers in the U.S. market, and we have increased the number of large employer customers utilizing our solutions from 121 as of December 31, 2009 to 540 as of September 30, 2014. We believe that our continued innovation and new solutions, such as online benefits marketplaces, also known as private exchanges, enhanced mobile offerings, and more robust data analytics capabilities will help us attract additional large employer customers and increase our revenue from existing customers.

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

**Table of Contents**

Our unaudited financial statements for the three and nine months ended September 30, 2013 reflect our restatement to correct an error in the accounting for its headquarters lease executed May 2005. The details of the restatement are fully described in the audited financial statements and related footnotes for the year ended December 31, 2013, included in our Annual Report on Form 10-K.

**Key Financial and Operating Performance Metrics**

We regularly monitor a number of financial and operating metrics in order to measure our current performance and project our future performance. These metrics help us develop and refine our growth strategies and make strategic decisions. We discuss revenue, gross margin, and the components of operating loss, as well as segment revenue and components of segment loss from operations, in Management's Discussion and Analysis of Financial Condition and Results of Operations Components of Operating Results. In addition, we utilize other key metrics as described below.

***Number of Large Employer and Carrier Customers***

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

	<b>As of September 30,</b>	
	<b>2014</b>	<b>2013</b>
Number of customers:		
Large employer	540	379
Carrier	44	37

***Software Services Revenue Retention Rate***

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

For the three- and nine-month periods ended September 30, 2014 and 2013 our software services revenue retention rate exceeded 95%.

***Adjusted Gross Profit and Adjusted EBITDA***

Adjusted gross profit represents our gross profit before depreciation and amortization, as well as stock-based compensation expense. Adjusted EBITDA represents our earnings before net interest, taxes, and depreciation and amortization expense, adjusted to eliminate stock-based compensation and impairment of goodwill and intangible assets. We believe that the exclusion of the expenses eliminated in calculating adjusted gross profit and adjusted EBITDA can provide a useful measure for period-to-period comparisons of our core business. Accordingly, we

believe that adjusted gross profit and adjusted EBITDA provide useful information to investors and others in understanding and evaluating our operating results. However, adjusted gross profit and adjusted EBITDA are not measures calculated in accordance with United States generally accepted accounting principles, or GAAP, and should not be considered as alternatives to any measures of financial performance calculated and presented in accordance with GAAP.

Our use of adjusted gross profit and adjusted EBITDA as analytical tools has limitations, and you should not consider them in isolation or as substitutes for analysis of our financial results as reported under GAAP. Some of these limitations are:

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

adjusted gross profit and adjusted EBITDA do not reflect changes in, or cash requirements for, our working capital needs;

adjusted gross profit and adjusted EBITDA do not reflect the potentially dilutive impact of stock-based compensation;

adjusted gross profit and adjusted EBITDA do not reflect interest or tax payments that would reduce the cash available to us; and

other companies, including companies in our industry, might calculate adjusted gross profit and adjusted EBITDA or similarly titled measures differently, which reduces their usefulness as comparative measures.

**Table of Contents**

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

	<b>Three Months Ended September 30, 2014</b>		<b>Nine Months Ended September 30, 2014</b>	
	<b>2013</b>		<b>2013</b>	
<b>Reconciliation from Gross Profit to Adjusted Gross Profit:</b>				
Gross profit	\$ 10,845	\$ 10,146	\$ 33,615	\$ 31,558
Depreciation	1,318	1,051	4,051	3,071
Amortization of software development costs	751	662	2,214	1,904
Amortization of acquired intangible assets	58	60	175	187
Stock-based compensation expense	327	57	619	188
Adjusted gross profit	\$ 13,299	\$ 11,976	\$ 40,674	\$ 36,908
<b>Reconciliation from Net Loss to Adjusted EBITDA:</b>				
Net loss	\$ (18,888)	\$ (6,836)	\$ (49,490)	\$ (22,079)
Depreciation	1,773	1,300	5,157	3,775
Amortization of software development costs	751	662	2,214	1,904
Amortization of acquired intangible assets	76	80	229	247
Interest income	(14)	(8)	(64)	(31)
Interest expense on building lease financing obligations	943	440	2,050	1,325
Interest expense on other borrowings	198	114	476	272
Income tax expense	(9)	(59)	20	(19)
Stock-based compensation expense	1,653	284	3,544	821
Total net adjustments	5,371	2,813	\$ 13,626	\$ 8,294
Adjusted EBITDA	\$ (13,517)	\$ (4,023)	\$ (35,864)	\$ (13,785)

**Components of Operating Results****Revenue**

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



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

	<b>Three Months Ended September 30,</b>		<b>Nine Months Ended September 30,</b>	
	<b>2014</b>	<b>2013</b>	<b>2014</b>	<b>2013</b>
Software services	\$ 30,688	\$ 24,523	\$ 89,019	\$ 69,448
Professional services	3,512	1,794	8,214	5,048
<b>Total revenue</b>	<b>\$ 34,200</b>	<b>\$ 26,317</b>	<b>\$ 97,233</b>	<b>\$ 74,496</b>

We generally recognize software services fees monthly based on the number of employees covered by the relevant benefits plans at contracted rates for a specified period of time, provided that an enforceable contract has been signed by both parties, access to our software has been granted to the customer and it is available for their use, the fee for the software services is fixed or determinable, and collection is reasonably assured. We defer recognition of our professional services fees paid by customers in connection with implementation of our software services, or implementation fees, and recognize them, beginning once the software services have commenced, ratably over the longer of the contract term or the estimated expected life of the customer relationship, currently 10 years. We periodically evaluate the term over which revenue is recognized for most professional services as we gain more experience with customer contract renewals.

We generally invoice our employer and carrier customers for software services in advance, in monthly installments. We invoice our employer customers for implementation fees at the inception of the arrangement. We generally invoice our carrier customers for implementation fees at various contractually defined times throughout the implementation process. Implementation fees that have been invoiced are initially recorded as deferred revenue until recognized as described above.

### ***Overhead Allocation***

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

### ***Cost of Revenue***

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

Our cost of revenue is expensed as we incur the costs. However, the related revenue from fees we receive for our implementation services performed before a customer is operating on our platform is deferred until the commencement of the monthly subscription and recognized as revenue ratably over the longer of the related contract term or the estimated expected life of the customer relationship. Therefore, the cost incurred in providing these services is expensed in periods prior to the recognition of the corresponding revenue. Our cost associated with providing implementation services has been significantly higher as a percentage of revenue than our cost associated with providing our monthly subscription services due to the labor associated with implementation.

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

---

**Table of Contents*****Operating Expenses***

Operating expenses consist of sales and marketing, research and development, and general and administrative expenses. Salaries and personnel-related costs are the most significant component of each of these expense categories. We expect to continue to hire new associates in these areas in order to support our anticipated revenue growth. As a result, we expect our operating expenses to increase in both aggregate dollars and as a percentage of revenue in the near term, but to decrease as a percentage of revenue over the longer term as we achieve economies of scale.

*Sales and marketing expense.* Sales and marketing expense consists primarily of salaries and other personnel-related costs, including benefits, bonuses, stock-based compensation, and commissions for our sales and marketing associates. We record expense for commissions at the time of contract signing. Additional expenses include advertising, lead generation, promotional event programs, corporate communications, travel, and allocated overhead. For instance, our most significant promotional event is One Place, which we hold annually in the second quarter. We expect our sales and marketing expense to increase in both absolute dollars and as a percentage of revenue in the foreseeable future as we further increase the number of our sales and marketing professionals and expand our marketing activities in order to continue to grow our business.

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

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

***Expense***

Other income and expense consists primarily of interest income and expense, accretion of contingent consideration, and gain (loss) on disposal of fixed assets. Interest income represents interest received on our cash and cash equivalents and marketable securities. Interest expense consists primarily of the interest incurred on outstanding borrowings under our financing obligations and capital leases, existing notes and credit facilities.

***Income Tax Expense***

Income tax expense consists of U.S. federal and state income taxes. We incurred minimal income tax (benefit) expense for the three- and nine-month periods ended September 30, 2014 and 2013.



**Table of Contents****Results of Operations*****Consolidated Statements of Operations Data***

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

	<b>Three Months Ended September 30,</b>		<b>Nine Months Ended September 30,</b>	
	<b>2014</b>	<b>2013</b>	<b>2014</b>	<b>2013</b>
Revenue	\$ 34,200	\$ 26,317	\$ 97,233	\$ 74,496
Cost of revenue <sup>(1)</sup>	23,355	16,171	63,618	42,938
Gross profit	10,845	10,146	33,615	31,558
Operating expenses:				
Sales and marketing <sup>(1)</sup>	12,105	7,354	37,159	27,096
Research and development <sup>(1)</sup>	11,469	6,527	30,619	16,824
General and administrative <sup>(1)</sup>	5,033	2,623	12,834	8,184
Change in fair value of contingent consideration				(43)
Total operating expenses	28,607	16,504	80,612	52,061
Loss from operations	(17,762)	(6,358)	(46,997)	(20,503)
Other income (expense):				
Interest income	14	8	64	31
Interest expense	(1,141)	(554)	(2,526)	(1,597)
Other (expense) income	(8)	9	(11)	(29)
Total other expense, net	(1,135)	(537)	(2,473)	(1,595)
Loss before income taxes	(18,897)	(6,895)	(49,470)	(22,098)
Income tax (benefit) expense	(9)	(59)	20	(19)
Net loss	\$ (18,888)	\$ (6,836)	\$ (49,490)	\$ (22,079)

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

	<b>Three Months Ended September 30,</b>		<b>Nine Months Ended September 30,</b>	
	<b>2014</b>	<b>2013</b>	<b>2014</b>	<b>2013</b>

(1) Stock-based compensation included in above line items:

Cost of revenue	\$ 327	\$ 57	\$ 619	\$ 188
Sales and marketing	341	29	876	93
Research and development	436	56	951	189
General and administrative	549	142	1,098	351

**Table of Contents**

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

	<b>Three Months Ended September 30,</b>		<b>Nine Months Ended September 30,</b>	
	<b>2014</b>	<b>2013</b>	<b>2014</b>	<b>2013</b>
Revenue	100.0%	100.0%	100.0%	100.0%
Cost of revenue	68.3	61.4	65.4	57.6
Gross profit	31.7	38.6	34.6	42.4
Operating expenses:				
Sales and marketing	35.4	27.9	38.2	36.4
Research and development	33.5	24.8	31.5	22.6
General and administrative	14.7	10.0	13.2	11.0
Change in fair value of contingent consideration				(0.1)
Total operating expenses	83.6	62.7	82.9	69.9
Loss from operations	(51.9)	(24.2)	(48.3)	(27.5)
Other income (expense):				
Interest income			0.1	
Interest expense	(3.3)	(2.1)	(2.6)	(2.1)
Other (expense) income				
Total other expense, net	(3.3)	(2.0)	(2.5)	(2.1)
Loss before income taxes	(55.3)	(26.2)	(50.9)	(29.7)
Income tax (benefit) expense		(0.2)		
Net loss	(55.2)%	(26.0)%	(50.9)%	(29.6)%

***Our Segments***

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

	<b>Three Months Ended September 30,</b>		<b>Nine Months Ended September 30,</b>	
	<b>2014</b>	<b>2013</b>	<b>2014</b>	<b>2013</b>
Revenue:				
Employer	\$ 14,937	\$ 9,823	\$ 42,503	\$ 27,417

Edgar Filing: Benefitfocus, Inc. - Form 10-Q

Carrier	19,263	16,494	54,730	47,079
Total revenue	\$ 34,200	\$ 26,317	\$ 97,233	\$ 74,496
Gross profit:				
Employer	\$ 1,968	\$ 2,437	\$ 10,161	\$ 9,565
Carrier	8,877	7,709	23,454	21,993
Total Gross Profit	\$ 10,845	\$ 10,146	\$ 33,615	\$ 31,558
(Loss) Income from operations:				
Employer	\$ (14,899)	\$ (6,879)	\$ (40,658)	\$ (18,923)
Carrier	(2,863)	521	(6,339)	(1,580)
Total operating loss	\$ (17,762)	\$ (6,358)	\$ (46,997)	\$ (20,503)



**Table of Contents****Comparison of Three Months Ended September 30, 2014 and 2013*****Revenue***

	Three Months Ended September 30,					
	2014		2013		Period-to-Period Change	
	Amount	Percentage of Revenue (in thousands)	Amount	Percentage of Revenue		
Software services	\$ 30,688	89.7%	\$ 24,523	93.2%	\$ 6,165	25.1%
Professional services	3,512	10.3	1,794	6.8	1,718	95.8
Total revenue	\$ 34,200	100.0%	\$ 26,317	100.0%	\$ 7,883	30.0%

Growth in software services revenue was primarily attributable to the addition of new customers, as the number of large employer and carrier customers increased to 584 as of September 30, 2014 from 416 as of September 30, 2013. The increase in professional services revenue of \$1.7 million between the three months ended September 30, 2013 and the three months ended September 30, 2014, is primarily due to the acceleration of the customer relationship period for certain customers of \$1.2 million and revenue recognized from newly completed implementations of \$0.7 million, offset by extensions and adjustments of customer relationship periods of \$0.3 million.

***Segment Revenue***

	Three Months Ended September 30,					
	2014		2013		Period-to-Period Change	
	Percentage of		Percentage of			
	Amount	Revenue	Amount	Revenue	Amount	Percentage
		(in thousands)				
Employer	\$ 14,937	43.7%	\$ 9,823	37.3%	\$ 5,114	52.1%
Carrier	19,263	56.3	16,494	62.7	2,769	16.8
Total revenue	\$ 34,200	100.0%	\$ 26,317	100.0%	\$ 7,883	30.0%

Growth in employer revenue was primarily attributable to a \$4.8 million increase in our employer software services revenue and a \$0.3 million increase in professional services revenue, driven primarily by an increase in the number of large employer customers using our platform as of September 30, 2014 as compared to September 30, 2013.

Growth in carrier revenue was primarily attributable to an increase of \$1.2 million in our carrier software services revenue and an increase of \$0.7 million in our carrier professional services revenues driven primarily by an increase in the number of carrier customers using our platform during the three months ended September 30, 2014 as compared to the three months ended September 30, 2013. The remaining increase of \$0.9 million is related to carrier professional services and is comprised of an increase of \$1.2 million from the acceleration of the customer relationship period for certain customers, offset by \$0.3 million from the extension and adjustment of the customer relationship period for certain customers.

***Cost of Revenue***

	Three Months Ended September 30,					
	2014			2013		
	Amount	Percentage of Revenue	(in thousands)	Amount	Percentage of Revenue	Percentage of Period-to-Period Change
						Amount Percentage
Cost of revenue	\$ 23,355	68.3%	\$ 16,171	61.4%	\$ 7,184	44.4%

The increase in cost of revenue was in part attributable to a \$6.0 million increase in salaries and personnel-related costs and professional fees, including an increase in stock-based compensation of \$0.3 million, of which \$4.9 million was associated with increased client service capacity to support our growing number of customers and an increase in engineering costs of \$0.5 million. Also, we experienced a \$1.2 million increase in infrastructure maintenance costs to support our platform and additional depreciation and amortization and facilities costs related to the increase in the number of employees.

**Gross Profit**

	Three Months Ended September 30, 2014		2013		Period-to-Period Change	
	Percentage of		Percentage of		Amount	
	Amount	Revenue (in thousands)	Amount	Revenue	Amount	Percentage
Software services	\$ 17,925	58.4%	\$ 15,534	63.3%	\$ 2,391	15.4%
Professional services	(7,080)	(201.6)	(5,388)	(300.3)	(1,692)	31.4
Gross profit	\$ 10,845	31.7%	\$ 10,146	38.6%	\$ 699	6.9%

The increase in software services gross profit in absolute terms was driven by a \$6.2 million, or 25.1%, increase in software services revenue. This increase was partially offset by a \$3.8 million, or 42.0%, increase in software services cost of revenue. Software services cost of revenue included \$0.2 million and \$19,000 of stock-based compensation expense for the three months ended September 30, 2014 and 2013, respectively, and \$1.9 million and \$1.6 million of depreciation and amortization for the three months ended September 30, 2014 and 2013, respectively.

The increase in professional services gross loss was driven by a \$3.4 million, or 47.5%, increase in professional services cost of revenue. This increase was partially offset by a \$1.7 million, or 95.8%, increase in professional services revenue. Professional services cost of revenue included \$0.2 million and \$38,000 of stock-based compensation expense for the three months ended September 30, 2014 and 2013, respectively. In addition, professional services cost of revenue included \$0.3 million and \$0.1 million in depreciation and amortization for the three months ended September 30, 2014 and 2013, respectively. As discussed in *Components of Operating Results Cost of Revenue*, our cost of revenue is expensed as we incur the costs. However, the related revenue from fees we receive for our implementation services performed before a customer is operating on our platform is deferred until the commencement of the monthly subscription and recognized as revenue ratably over the longer of the related contract term or the estimated expected life of the customer relationship, which is currently 10 years. Therefore, the cost incurred in providing these services is expensed in periods prior to the recognition of the corresponding revenue. For this reason, as well as due to the personnel-related costs associated with providing implementation services, our cost associated with providing implementation services has been significantly higher as a percentage of related revenue than our cost associated with providing our monthly subscription services.

**Segment Gross Profit**

	Three Months Ended September 30, 2014		2013		Period-to-Period Change	
	Percentage of		Percentage of		Amount	
	Amount	Revenue (in thousands)	Amount	Revenue	Amount	Percentage
Employer	\$ 1,968	13.2%	\$ 2,437	24.8%	\$ (469)	(19.2)%
Carrier	8,877	46.1	7,709	46.7	1,168	15.2
Gross profit	\$ 10,845	31.7%	\$ 10,146	38.6%	\$ 699	6.9%

Employer gross profit decreased by \$0.5 million, or 19.2%, between the three months ended September 30, 2013 and the three months ended September 30, 2014. The \$5.1 million, or 52.1%, increase in employer revenue was offset by a \$5.6 million, or 75.6%, increase in employer cost of revenue. The increase in cost of revenue is primarily attributable to costs associated with providing implementation services, which increased due to a higher number of new employer

customer implementations. Our employer gross profit included \$1.0 million and \$0.5 million of depreciation and amortization for the three months ended September 30, 2014 and September 30, 2013, respectively. In addition, our employer gross profit included \$0.2 million and \$27,000 of stock-based compensation expense for the three months ended September 30, 2014 and 2013, respectively.

**Table of Contents**

Carrier gross profit increased by \$1.2 million, or 15.2%, between the three months ended September 30, 2013 and the three months ended September 30, 2014. The \$2.8 million, or 16.8%, increase in carrier revenue was offset by a \$1.6 million, or 18.2%, increase in carrier cost of revenue. The increase in cost of revenue is primarily attributable to new carrier customers and product implementations. Our carrier gross profit included \$1.1 million and \$1.2 million in depreciation and amortization for the three months ended September 30, 2014 and September 30, 2013, respectively. In addition, our carrier gross profit included \$0.2 million and \$30,000 of stock-based compensation expense for the three months ended September 30, 2014 and 2013, respectively.

***Sales and Marketing***

	Three Months Ended September 30,					
	2014			2013		
	Percentage of		Amount	Percentage of Period-to-Period Change		Amount
	Amount	Revenue		Revenue	Percentage	
	(in thousands)					
Sales and marketing	\$ 12,105	35.4%	\$ 7,354	27.9%	\$ 4,751	64.6%

The increase in sales and marketing expense in absolute terms was primarily attributable to a \$3.5 million increase in salaries and personnel-related costs, including an increase in stock-based compensation of \$0.3 million, due to sales and marketing associates hired to continue driving revenue growth and \$0.3 million related to sales and marketing events, and \$0.9 million related to increases in travel-related costs, recruiting, other operating costs, and allocation of overhead driven by an increase in the number of employees.

***Research and Development***

	Three Months Ended September 30,					
	2014			2013		
	Percentage of		Amount	Percentage of		Period-to-Period Change
	Amount	Revenue		Revenue	Amount	
(in thousands)						
Research and development	\$ 11,469	33.5%	\$ 6,527	24.8%	\$ 4,942	75.7%

The increase in research and development expense was primarily attributable to a \$2.8 million increase in salaries and personnel-related costs, including an increase in stock-based compensation of \$0.4 million, due to additional research and development headcount. Additionally, we experienced a \$1.5 million increase in engineering consulting fees for assistance in product development. Also, we experienced a \$0.5 million increase in infrastructure maintenance costs to support our platform and additional depreciation and amortization and facilities costs related to the growth in headcount.

***General and Administrative***

	Three Months Ended September 30,		
	2014		2013
	Amount	Amount	Period-to-Period Change

	<b>Percentage of Revenue (in thousands)</b>		<b>Percentage of Revenue</b>		<b>Amount</b>	<b>Percentage</b>
General and administrative	\$ 5,033	14.7%	\$ 2,623	10.0%	\$ 2,410	91.9%

The increase in general and administrative expense was primarily attributable to a \$0.9 million increase in salaries and personnel-related costs, including an increase in stock-based compensation of \$0.4 million, due to additional general and administrative headcount. Additionally, we experienced a \$0.3 million increase in consulting and professional fees related to being a publicly traded company, a \$0.6 million increase in other operating expenses and \$0.3 million in costs associated with our follow-on offering on July 17, 2014.

**Segment (Loss) Income From Operations**

	Three Months Ended September 30,					
	2014		2013		Period-to-Period Change	
	Amount	Percentage of Revenue (in thousands)	Amount	Percentage of Revenue		
Employer	\$ (14,899)	(99.7)%	\$ (6,879)	(70.0)%	\$ (8,020)	116.6%
Carrier	(2,863)	(14.9)	521	3.2	(3,384)	(649.5)
Loss from operations	\$ (17,762)	(51.9)%	\$ (6,358)	(24.2)%	\$ (11,404)	179.4%

The increase in employer loss from operations was attributable to an increase in employer operating expenses of \$7.6 million. The increase in operating expenses was primarily attributable to a \$3.0 million increase in research and development expense and a \$3.4 million increase in sales and marketing expense. The increase in sales and marketing expense was attributable to hiring of employer sales associates to continue driving revenue growth. The increase in research and development expense was primarily driven by a headcount increase to work on improving and expanding our existing products and technology infrastructure to allow further growth in employer customer base.

The increase in carrier loss from operations was attributable to an increase in gross margin of \$1.2 million, offset by an increase in operating expenses of \$4.6 million. The increase in operating expenses was primarily attributable to an increase of \$2.0 million and \$1.4 million in research and development and sales and marketing expenses, respectively. The increases in research and development expense and sales and marketing expense were primarily driven by increases in headcount to support our growing business.

**Comparison of Nine Months Ended September 30, 2014 and 2013****Revenue**

	Nine Months Ended September 30,					
	2014		2013		Period-to-Period Change	
	Amount	Percentage of Revenue (in thousands)	Amount	Percentage of Revenue		
Software services	\$ 89,019	91.6%	\$ 69,448	93.2%	\$ 19,571	28.2%
Professional services	8,214	8.4	5,048	6.8	3,166	62.7
Total revenue	\$ 97,233	100.0%	\$ 74,496	100.0%	\$ 22,737	30.5%

Growth in software services revenue was primarily attributable to the addition of new customers, as the number of large employer and carrier customers increased to 584 as of September 30, 2014 from 416 as of September 30, 2013. Our professional services revenue increased between the nine months ended September 30, 2013 and the nine months ended September 30, 2014, was primarily due to revenue recognized from newly completed implementations of \$2.2 million, in addition to the acceleration of the customer relationship period for certain customers of \$1.0 million.

**Table of Contents*****Segment Revenue***

	Nine Months Ended September 30,					
	2014		2013		Period-to-Period Change	
	Percentage of		Percentage of			
	Amount	Revenue (in thousands)	Amount	Revenue	Amount	Percentage
Employer	\$ 42,503	43.7%	\$ 27,417	36.8%	\$ 15,086	55.0%
Carrier	54,730	56.3	47,079	63.2	7,651	16.3
Total revenue	\$ 97,233	100.0%	\$ 74,496	100.0%	\$ 22,737	30.5%

The growth in our employer revenue was primarily attributable to a \$14.5 million increase in our employer software services revenue driven primarily by an increase in the number of large employer customers using our platform as of September 30, 2014 as compared to September 30, 2013. In addition, the increase in employer professional services of \$0.6 million is primarily related to newly completed implementations.

The growth in our carrier revenue was primarily attributable to an increase of \$5.0 million in our carrier software services revenue driven primarily by a increase in the number of carrier customers using our platform, as well as an increase in the number of products being utilized by our carrier customers during the nine months ended September 30, 2014 as compared to the nine months ended September 30, 2013. The remaining increase of \$2.5 million is related to carrier professional services and is comprised of an increase of \$1.7 million in new customers who went live on the platform, \$1.1 million related to the acceleration of the customer relationship period for certain customers, offset by \$0.3 million from the extension and adjustment of the customer relationship period for certain customers.

***Cost of Revenue***

	Nine Months Ended September 30,					
	2014		2013		Period-to-Period Change	
	Percentage of		Percentage of			
	Amount	Revenue	Amount	Revenue	Amount	Percentage
	(in thousands)					
Cost of revenue	\$ 63,618	65.4%	\$ 42,938	57.6%	\$ 20,680	48.2%

The increase in cost of revenue was in part attributable to a \$14.5 million increase in salaries and personnel-related costs and professional fees, including an increase of \$0.4 million related to stock-based compensation, of which \$12.9 million was associated with increased client service capacity to support our growing number of customers and an increase in engineering costs of \$0.9 million. Also, we experienced a \$6.2 million increase in infrastructure maintenance costs to support our platform and additional depreciation and amortization and facilities costs related to the increase in the number of employees.

***Gross Profit***



	Nine Months Ended September 30, 2014		2013		Period-to-Period Change	
	Amount	Percentage of	Amount	Percentage of	Amount	Percentage
		Revenue (in thousands)		Revenue		
Software services	\$ 52,149	58.6%	\$ 44,445	64.0%	\$ 7,704	17.3%
Professional services	(18,534)	(225.6)	(12,887)	(255.3)	(5,647)	43.8
Gross profit	\$ 33,615	34.6%	\$ 31,558	42.4%	\$ 2,057	6.5%

The increase in software services gross profit in absolute terms was driven by a \$19.6 million, or 28.2%, increase in software services revenue. This increase was partially offset by a \$11.9 million, or 47.5%, increase in software services cost of revenue. Software services cost of revenue included \$0.3 million and \$65,000 of stock-based compensation expense for the nine months ended September 30, 2014 and 2013, respectively, and \$5.9 million and \$4.9 million of depreciation and amortization for the nine months ended September 30, 2014 and 2013, respectively.

The increase in professional services gross loss was driven by an \$8.8 million, or 49.1%, increase in professional services cost of revenue, partially offset by an increase in professional services revenue of \$3.2 million. Professional services cost of revenue included \$0.3 million and \$0.1 million of stock-based compensation expense for the nine months ended September 30, 2014 and 2013, respectively. In addition, professional services cost of revenue included \$0.5 million and \$0.3 million in depreciation and amortization for the nine months ended September 30, 2014 and 2013, respectively. As discussed in *Components of Operating Results Cost of Revenue*, our cost of revenue is expensed as we incur the costs. However, the related revenue from fees we receive for our implementation services performed before a customer is operating on our platform is deferred until the commencement of the monthly subscription and recognized as revenue ratably over the longer of the related contract term or the estimated expected life of the customer relationship, which is currently 10 years. Therefore, the cost incurred in providing these services is expensed in periods prior to the recognition of the corresponding revenue. For this reason, as well as due to the personnel-related costs associated with providing implementation services, our cost associated with providing implementation services has been significantly higher as a percentage of related revenue than our cost associated with providing our monthly subscription services.

### *Segment Gross Profit*

	Nine Months Ended September 30,					
	2014		2013		Period-to-Period Change	
	Amount	Percentage of	Amount	Percentage of		
		Revenue		Revenue	Amount	Percentage
		(in thousands)				
Employer	\$ 10,161	23.9%	\$ 9,565	34.9%	\$ 596	6.2%
Carrier	23,454	42.9	21,993	46.7	1,461	6.6
Gross profit	\$ 33.615	34.6%	\$ 31.558	42.4%	\$ 2.057	6.5%

Employer gross profit increased in absolute terms by \$0.6 million, or 6.2%, between the nine months ended September 30, 2013 and the nine months ended September 30, 2014. The \$15.1 million, or 55.0%, increase in employer revenue was offset by a \$14.5 million, or 81.2%, increase in employer cost of revenue. The increase in cost of revenue is attributable to costs associated with supporting the increased number of employer customers live on the platform and the increased cost of providing services, including customer implementations. Our employer gross profit included \$2.8 million and \$1.8 million of depreciation and amortization for the nine months ended September 30, 2014 and September 30, 2013, respectively. In addition, our employer gross profit included \$0.3 million and \$76,000 of stock-based compensation expense for the nine months ended September 30, 2014 and 2013, respectively.

Carrier gross profit increased by \$1.5 million, or 6.6%, between the nine months ended September 30, 2013 and the nine months ended September 30, 2014. The \$7.7 million, or 16.3%, increase in carrier revenue was offset by a \$6.2 million, or 24.7%, increase in carrier cost of revenue. The increase in cost of revenue is attributable to costs associated with supporting the increased number of carrier customers live on the platform and the increased cost of providing services, including customer implementations. Our carrier gross profit included \$3.7 million and \$3.4 million in depreciation and amortization for the nine months ended September 30, 2014 and September 30, 2013, respectively. In addition, our carrier gross profit included \$0.3 million and \$0.1 million of stock-based compensation expense for the nine months ended September 30, 2014 and 2013, respectively.

**Table of Contents*****Sales and Marketing***

	Nine Months Ended September 30,					
	2014			2013		
	Amount	Percentage of Revenue (in thousands)	Amount	Percentage of Revenue	Amount	Period-to-Period Change Percentage
Sales and marketing	\$ 37,159	38.2%	\$ 27,096	36.4%	\$ 10,063	37.1%

The increase in sales and marketing expense was primarily attributable to a \$6.2 million increase in salaries and personnel-related costs, including an increase in stock-based compensation of \$0.8 million, due to sales and marketing associates hired to continue driving revenue growth and \$1.7 million related to sales and marketing events, \$1.4 million related to increases in facilities and overhead allocation, recruiting and other operating costs driven by an increase in the number of employees, and \$0.6 million in travel-related costs.

***Research and Development***

	Nine Months Ended September 30,					
	2014			2013		
	Amount	Percentage of Revenue (in thousands)	Amount	Percentage of Revenue	Amount	Period-to-Period Change Percentage
Research and development	\$ 30,619	31.5%	\$ 16,824	22.6%	\$ 13,795	82.0%

The increase in research and development expense was primarily attributable to a \$8.1 million increase in salaries and personnel-related costs, including an increase in stock-based compensation of \$0.8 million, due to additional research and development headcount. Additionally, we experienced a \$4.3 million increase in engineering consulting fees for assistance in product development and \$1.4 million related to increases in facilities and overhead allocation, other operating costs, and travel-related costs driven by an increase in the number of employees.

***General and Administrative***

	Nine Months Ended September 30,					
	2014			2013		
	Amount	Percentage of Revenue (in thousands)	Amount	Percentage of Revenue	Amount	Period-to-Period Change Percentage
General and administrative	\$ 12,834	13.2%	\$ 8,184	11.0%	\$ 4,650	56.8%

The increase in general and administrative expense was primarily attributable to a \$2.4 million increase in consulting and professional fees, and insurance related to being a publicly traded company, including \$0.7 million in costs related to our follow-on offering on July 17, 2014. Additionally, we experienced a \$1.4 million increase in salaries and personnel-related costs, including a \$0.7 million increase in stock-based compensation expense due to increased headcount. In addition, we experienced a \$0.6 million increase related to increases in facilities and overhead allocation, and other costs.

**Segment Loss From Operations**

	Nine Months Ended September 30,					
	2014		2013			
	Amount	Percentage of Revenue (in thousands)	Amount	Percentage of Revenue	Period-to-Period Change Amount	Percentage
Employer	\$ (40,658)	(95.7)%	\$ (18,923)	(69.0)%	\$ (21,735)	114.9%
Carrier	(6,339)	(11.6)	(1,580)	(3.4)	(4,759)	301.2
Loss from operations	\$ (46,997)	(48.3)%	\$ (20,503)	(27.5)%	\$ (26,494)	129.2%

The increase in employer loss from operations was attributable to an increase in employer operating expenses of \$22.3 million. The increase in operating expenses was primarily attributable to a \$9.8 million increase in research and development expense and a \$9.8 million increase in sales and marketing expense. The increase in sales and marketing expense was attributable to hiring of employer sales associates to continue driving revenue growth. The increase in research and development expense was primarily driven by a headcount increase to work on improving and expanding our existing products and technology infrastructure to allow further growth in employer customer base.

The increase in carrier loss from operations was attributable to an increase in gross profit of \$1.5 million, offset by a \$6.2 million increase in operating expenses. The increase in operating expenses was primarily attributable an increase of \$4.0 million and \$2.0 million in research and development and general and administrative expenses, respectively. The increases in research and development expense and general and administrative expense were primarily driven by increases in headcount to support our growing business.

**Critical Accounting Policies and Significant Judgments 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 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. During the nine months ended September 30, 2014, there were no material changes to our critical accounting policies and use of estimates, which are disclosed in our Annual Report on Form 10-K for the year ended December 31, 2013.

**Liquidity and Capital Resources****Sources of Liquidity**

On August 27, 2013, we entered into a loan and security agreement with Silicon Valley Bank to provide us a revolving line of credit of up to \$35.0 million to be used for working capital, to refinance our indebtedness to NBSC, and to fund our general business requirements. Amounts borrowed under the line of credit are payable on the maturity date, which is August 27, 2016. Amounts borrowed may be repaid and re-borrowed prior to the maturity date. Borrowing capacity under the line of credit is subject to a borrowing base limit that is a function of our monthly recurring revenue as adjusted to reflect lost customer revenue during the previous quarter. In August 2014, the borrowing limit under the line of credit was increased from \$15.0 million to \$35.0 million in accordance with the

terms of the agreement.

---

**Table of Contents**

We can designate advances as LIBOR advances or prime rate advances. LIBOR advances bear interest at 2.75% plus the greater of 0.50% or current LIBOR for the applicable period, generally 30 days, adjusted for certain regulatory reserve requirements. The LIBOR rate is adjusted approximately monthly. Prime Rate advances bear interest at the prime rate as published in the Wall Street Journal. The interest rate on prime rate advances is adjusted on the effective date of a change in the prime rate.

We made customary affirmative and negative covenants in connection with the loan and security agreement, including financial covenants related to liquidity and revenue growth. In the event of a default, including, among other things, our failure to pay any principal or interest payment when due or our uncured default of any term, provision, condition, covenant or agreement, Silicon Valley Bank may declare all obligations immediately due and stop advancing money or extending credit under the line of credit. The line of credit is collateralized by substantially all of our tangible and intangible assets, including any proceeds of intellectual property (but not the underlying intellectual property itself), and we have agreed not to encumber any of our intellectual property without Silicon Valley bank's prior written consent. The collateral also excludes any equity interests.

On August 30, 2013, we borrowed \$5.8 million under this line of credit, which we used to repay all of the amounts outstanding under two promissory notes and our prior master credit facility. In June 2014, we borrowed an additional \$7.0 million under its line of credit, which was used to fund our general operations. As of September 30, 2014, the amount outstanding under this line of credit was \$12.8 million and the amount available to borrow, adjusted by the borrowing base limit, was \$17.4 million. However, as recurring revenue grows, remaining borrowing capacity could expand to \$22.2 million.

On September 23, 2013, we closed our IPO in which we sold 3,000,000 shares of common stock at a public offering price of \$26.50 per share, resulting in net proceeds of \$70.1 million.

Based on our current level of operations and anticipated growth, we believe our future cash flows from operating activities, existing cash balances, which include the net proceeds from our IPO, and amounts available under our line of credit will be sufficient to meet our cash requirements for at least the next 12 months.

Going forward, we may access capital markets to raise additional equity or debt financing for various business reasons, including additional working capital to fund operations and anticipated growth, required debt payments and acquisitions. The timing, size, and pricing of any such financing will depend on investor interest and market conditions, and there can be no assurance that we will be able to obtain any such financing.

***Financing and Capital Lease Obligations***

In March 2014, we entered into a capital lease and financing obligation to finance data processing equipment and software and support. Payments total \$4.4 million, including a down payment of \$1.6 million and aggregate monthly payments, which commenced in April 2014, of \$2.8 million for a term of 36 months.

In connection with our December 2013 build-to-suit lease for additional office space for which we are deemed the owner for accounting purposes, we have recorded construction in process of \$11.4 million and a financing obligation of \$12.1 million as of September 30, 2014. Increases in the construction in process asset and financing obligation liability do not represent payments made during the period by us but rather represent cost incurred by the entity constructing the building. We will begin making payments related to this lease in 2015.

***Cash Flows***

The following table summarizes our cash flows for the periods indicated:

	<b>Nine Months Ended September 30, 2014                      2013 (in thousands)</b>	
Cash provided by (used in):		
Operating activities	\$ (12,680)	\$ 3,632
Investing activities	(2,114)	(6,686)
Financing activities	2,925	68,023

*Operating Activities*

For the nine months ended September 30, 2014, our operating activities used \$12.7 million of cash, as \$22.9 million of cash provided by changes in working capital and \$13.9 million in adjustments for non-cash items, were more than offset by a net loss of \$49.5 million. Adjustments for non-cash items primarily consisted of depreciation and amortization expense of \$7.6 million, accrual of interest on financing obligations of \$2.1 million, non-cash stock compensation expense of \$3.5 million, and change in fair value and accretion of warrant of \$0.7 million. The cash provided by changes in working capital primarily consisted of an increase in deferred

---

**Table of Contents**

revenue of \$11.2 million, an increase in accrued compensation and benefits of \$4.1 million, an increase in accrued expenses of \$1.4 million, and a decrease in accounts receivable of \$5.7 million. The increase in deferred revenue was a result of contracts closed during the period with associated upfront fees, which will be recognized as revenue, ratably over the customer relationship period, beginning once the software services have commenced. The increase in accrued compensation and benefits resulted from an increase in the number of associates. The decrease in accounts receivable resulted from normal timing of customer payments. The increase in accrued expenses resulted from an increase in cost of revenue and operating expenses. These increases were partially offset by a decrease in operating cash flow due to a \$1.3 million decrease in accounts payable that was primarily attributable to normal fluctuations and timing of expense payments.

For the nine months ended September 30, 2013, our net cash and cash equivalents provided by operating activities of \$3.6 million consisted of \$16.9 million of cash provided by changes in working capital and \$8.8 million in adjustments for non-cash items, partially offset by a net loss of \$22.1 million. Adjustments for non-cash items primarily consisted of depreciation and amortization expense of \$5.9 million, accrual of interest on financing obligations of \$1.3 million, non-cash stock compensation expense of \$0.8 million, and change in fair value and accretion of warrant of \$0.7 million. The cash provided by changes in working capital primarily consisted of an increase in deferred revenue of \$14.8 million, an increase in accrued compensation and benefits of \$6.1 million, and an increase in accounts payable and accrued expenses of \$4.6 million. The increase in deferred revenue was a result of contracts closed during the period with associated upfront fees, which will be recognized as revenue, ratably over the customer relationship period, beginning once the software services have commenced. The increase in accrued compensation and benefits resulted from normal fluctuation in payroll dates and an increase in the number of associates. The increase in accounts payable resulted from an increase in cost of revenue and operating expenses. These increases were partially offset by a decrease in operating cash flow due to a \$7.9 million increase in accounts receivable and a \$1.0 million increase in prepaid expenses and other current assets. The increase in accounts receivable was primarily attributable to increased revenue and fees not yet recognized as revenue in the nine months ended September 30, 2013.

*Investing Activities*

For the nine months ended September 30, 2014 and 2013, net cash used for the purchase of property and equipment was \$8.0 million and \$6.7 million, respectively. During the nine months ended September 30, 2014, the net maturity of short-term investments held to maturity provided \$5.9 million.

*Financing Activities*

For the nine months ended September 30, 2014, net cash provided by financing activities was \$2.9 million, consisting of a \$7.0 million draw on revolving line of credit and \$2.7 million in proceeds from exercises of stock options, offset by \$6.8 million in payments on financing and capital lease obligations.

On March 28, 2014, a major customer exercised its warrant through a cashless exercise in accordance with the warrant's terms, resulting in the issuance of 455,521 shares of common stock. The measured value of the warrant will continue to be recognized against revenue for the remainder of the contract term, ending in October 2014.

For the nine months ended September 30, 2013, net cash provided by financing activities was \$68.0 million, consisting of \$70.1 million in proceeds from our IPO, net of issuance costs, \$12.2 million in proceeds from line of credit and notes payable borrowings, partially offset by \$14.9 million in repayments of notes payable, line of credit, financing obligations, and capital leases.



## **Commitments**

In February 2013, we amended a 2009 office lease agreement to expand the office space rented under the lease. This amendment increases our commitment by \$9.9 million over the term which started in January 2014 and continues through June 2024. This agreement is with an entity with which two of our directors, significant stockholders, and executives are affiliated.

In May 2014, we entered into a sublease for additional office space in North Charleston, South Carolina. The lease commenced June 1, 2014 and continues until January 31, 2018. The terms of lease contain a rent concession of four months. Expenses related to this lease total approximately \$52,000 per quarter.

In September 2014, we amended our office lease for additional space in Greenville, South Carolina. The amended lease will commence January 1, 2015 and continue until February 28, 2020. The terms of lease contain a rent concession of two months. Expenses related to this lease total approximately \$95,000 per quarter.

### **Off-Balance Sheet Arrangements**

As of September 30, 2014, we did not have any off-balance sheet arrangements, as defined in Item 303(a)(4)(ii) of Regulation S-K of the Securities Act, such as the use of unconsolidated subsidiaries, structured finance, special purpose entities or variable interest entities.

### **Recent Accounting Pronouncements**

In July 2013, the Financial Accounting Standards Board ( FASB ) issued Accounting Standards Update ( ASU ) No. 2013-11, Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit

---

**Table of Contents**

Carryforward Exists . ASU 2013-11 allows an unrecognized tax benefit, or a portion of an unrecognized tax benefit, to be presented in the financial statements as a reduction to a deferred tax asset for a net operating loss carryforward, a similar tax loss, or a tax credit carryforward, with one exception. The exception states that, to the extent a net operating loss carryforward, a similar tax loss, or a tax credit carryforward is not available at the reporting date under the tax law of the applicable jurisdiction to settle any additional income taxes that would result from the disallowance of a tax position or the tax law of the applicable jurisdiction does not require the entity to use, and the entity does not intend to use, the deferred tax asset for such purpose, the unrecognized tax benefit should be presented in the financial statements as a liability and should not be combined with deferred tax assets. The assessment of whether a deferred tax asset is available is based on the unrecognized tax benefit and deferred tax asset that exist at the reporting date and should be made presuming disallowance of the tax position at the reporting date. ASU 2013-11 is effective for fiscal years, and interim periods within those years, beginning after December 15, 2013. The adoption of this guidance did not have an impact on our consolidated financial statements.

In May 2014, the FASB issued ASU No. 2014-09 Revenue from Contracts with Customers , which amends the revenue recognition requirements in the FASB Accounting Standards Codification (ASC). This statement requires that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. The statement shall be applied using one of two methods: retrospectively to each prior reporting period presented, or retrospectively with the cumulative effect of initially applying this statement recognized at the date of initial application. We have not yet determined which method it will apply. This statement is effective for annual reporting periods beginning after December 15, 2016, including interim periods within that reporting period. Early adoption is not permitted. We are currently evaluating the impact of this statement on our consolidated financial position or results of operations.

**Table of Contents**

**ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

Market risk is the risk of loss to future earnings, values or future cash flows that may result from changes in the price of a financial instrument. The value of a financial instrument might change as a result of changes in interest rates, exchange rates, commodity prices, equity prices and other market changes. We do not use derivative financial instruments for speculative, hedging or trading purposes, although in the future we might enter into exchange rate hedging arrangements to manage the risks described below.

***Interest Rate Risk***

We are exposed to market risk related to changes in interest rates. Borrowings under the revolving line of credit with Silicon Valley Bank, which we entered into in August 2013, bear interest at variable rates. Increases in the LIBOR or Prime Rate would increase the amount of interest payable under this line of credit. Borrowings outstanding under our previous credit arrangements were not subject to interest rate risk because they bore interest at fixed rates.

***Interest Rate Sensitivity***

We are subject to interest rate risk in connection with borrowings under our revolving line of credit, which are subject to a variable interest rate. At September 30, 2014, we had borrowings under our revolving line of credit of \$12.8 million. As a result, each change of one percentage point in interest rates would result in an approximate \$0.1 million change in our annual interest expense on our outstanding borrowings at September 30, 2014. Any debt we incur in the future may also bear interest at variable rates.

***Inflation Risk***

We do not believe that inflation has had a material effect on our business, financial condition, or results of operations. We continue to monitor the impact of inflation in order to minimize its effects through pricing strategies, productivity improvements and cost reductions. If our costs were to become subject to significant inflationary pressures, we might 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.

---

**Table of Contents**

**ITEM 4. CONTROLS AND PROCEDURES**

**(a) Evaluation of Disclosure Controls and Procedures**

Under the supervision and with the participation of our management, including our President and Chief Executive Officer, and our Chief Financial Officer, we conducted an evaluation of the effectiveness of the design and operation of our disclosure controls and procedures, as defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act, as of the end of the period covered by this report.

In designing and evaluating our disclosure controls and procedures, management recognizes that any disclosure controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives. In addition, the design of disclosure controls and procedures must reflect the fact that there are resource constraints and that management is required to apply its judgment in evaluating the benefits of possible controls and procedures relative to their costs.

As previously reported, in the first quarter of 2014, we identified a material weakness in internal controls over the accounting for leasing transactions which resulted in the identification of a material error in the accounting for our headquarters lease executed in May 2005. This material error resulted from our incorrect interpretation of standards under ASC 840, Leases, related to this build-to-suit lease where we, as the lessee, were involved in asset construction. To correct the error, we restated our financial statements related to the period ended September 30, 2013 in Amendment No. 1 to Quarterly Report on Form 10-Q/A, filed with the SEC on March 21, 2014, and our consolidated financial statements as of December 31, 2012 and 2011 and for each of the three years in the period ended December 31, 2012 in our Annual Report on Form 10-K, filed with the SEC on March 21, 2014. Management also reviewed all of our leases to identify and correct instances where we were not complying with generally accepted accounting principles with regard to lease accounting. Management developed updated procedures to reflect the technical guidance for lease accounting and has engaged external technical resources to assist with the proper implementation of accounting standards for leases. The implementation and continued operation of these remedial controls lead management to conclude that the material weakness in internal controls over the accounting for leasing transactions has been remediated as of September 30, 2014.

Based on their evaluation, our President and Chief Executive Officer, and our Chief Financial Officer also concluded that our disclosure controls and procedures are designed to, and are effective to, provide assurance at a reasonable level that the information we are required to disclose in reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in SEC rules and forms, and that such information is accumulated and communicated to our management, including our President and Chief Executive Officer, and our Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosures.

**(b) Changes in Internal Control Over Financial Reporting**

Under the supervision and with the participation of our management, including our President and Chief Executive Officer, and our Chief Financial Officer, we conducted an evaluation of any changes in our internal control over financial reporting (as such term is defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) that occurred during the fiscal quarter ended September 30, 2014. Based on that evaluation, our President and Chief Executive Officer, and our Chief Financial Officer concluded that, other than the implementation and continued operation of the remedial actions discussed above, there has not been any material change in our internal control over financial reporting during the quarter ended September 30, 2014 that materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.



## **Table of Contents**

## **PART II. OTHER INFORMATION**

### **ITEM 1A. RISK FACTORS**

*Investing in our common stock involves a high degree of risk. You should consider carefully the risks and uncertainties described below, together with all of the other information in this Quarterly Report on Form 10-Q, including the consolidated financial statements and the related notes, before deciding to invest in shares of our common stock. If any of the following risks were to materialize, our business, financial condition, results of operations, and future growth prospects could be materially and adversely affected. In that event, the market price of our common stock could decline and you could lose part or all of your investment in our common stock.*

#### **Risks Related to Our Business**

*We have had a history of losses, and we might not be able to achieve or sustain profitability.*

We experienced net losses of \$30.4 million, \$14.9 million, and \$15.1 million for the years ended December 31, 2013, 2012, and 2011, respectively and net losses of \$49.5 million and \$22.1 million for the nine months ended September 30, 2014 and 2013, respectively. We cannot predict if we will achieve sustained profitability in the near future or at all. We expect to make significant future expenditures to develop and expand our business. In addition, as a public company, we incur significant legal, accounting, and other expenses that we did not incur as a private company. These increased expenditures will make it harder for us to achieve and maintain future profitability. Our recent growth in revenue and number of customers might not be sustainable, and we might not achieve sufficient revenue to achieve or maintain profitability. We could incur significant losses in the future for a number of reasons, including the other risks described in this Quarterly Report on Form 10-Q, and we may encounter unforeseen expenses, difficulties, complications and delays and other unknown events. Accordingly, we might not be able to achieve or maintain profitability and we may incur significant losses for the foreseeable future.

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

Our quarterly operating results might 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 might not be meaningful. You should not rely on our past results as indicative of our future performance. 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 the expectations of investors or securities analysts, the price of our common stock could decline substantially. For example, on March 7, 2014, the first trading day after we publically announced December 31, 2013 results and 2014 guidance, our stock price dropped almost \$5.00 per share, or 7.3%, to \$63.45.

Our operating results have varied in the past. 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 and services achieve or maintain market acceptance;

our ability to introduce new products and services and enhancements to our existing products and services on a timely basis;

new competitors and the introduction of enhanced products and services from competitors;

the financial condition of our current and potential customers;

changes in customer budgets and procurement policies;

the amount and timing of our investment in research and development activities;

technical difficulties with our products or interruptions in our services;

our ability to hire and retain qualified personnel, including the rate of expansion of our sales force;

changes in the regulatory environment related to benefits and healthcare;

regulatory compliance costs;

the timing, size, and integration success of potential future acquisitions; and

unforeseen legal expenses, including litigation and settlement costs.

In addition, a significant portion of our operating expense is relatively fixed in nature, and planned expenditures are based in part on expectations regarding future revenue. Accordingly, unexpected revenue shortfalls might decrease our gross margins and could cause significant changes in our operating results from quarter to quarter. If this occurs, the trading price of our common stock could fall substantially, either suddenly or over time.



---

**Table of Contents**

***As a result of our variable sales and implementation cycles, we might not be able to recognize revenue to offset expenditures, which could result in fluctuations in our quarterly results of operations or otherwise harm our future operating results.***

The sales cycle for our products and services can be variable, averaging four months in our employer market segment and 15 months in our carrier market segment, each from initial contact to contract execution. During the sales cycle, we expend time and resources, and we do not recognize any revenue to offset such expenditures.

After a customer contract is signed, we provide an implementation process for the customer during which we establish and test appropriate integrations, connections and registrations, load data into our system, and train customer personnel. Our implementation cycle is also variable, typically ranging from four to five months for employer implementations and from eight to 10 months for complex carrier implementations, each from contract execution to completion of implementation. Some of our new customer projects are complex and require a lengthy set-up period and significant implementation work. During the implementation cycle, we expend substantial time, effort, and financial resources implementing our products and services, but accounting principles do not allow us to recognize the resulting revenue until implementation is complete and the services are available for use, at which time we begin recognition of implementation revenue over the longer of the life of the contract or the expected life of the customer relationship. Each customer's situation is different, and unanticipated difficulties and delays might arise as a result of failure by us or by the customer to complete our respective responsibilities. If implementation periods are extended, revenue recognition could be delayed and our financial condition might be adversely affected. In addition, cancellation of any implementation after it has begun might result in lost time, effort, and expenses invested in the cancelled implementation process and lost opportunity for implementing paying clients in that same period of time.

These factors might contribute to continuing losses and substantial fluctuations in our quarterly operating results. As a result, in future quarters, our operating results could fall below the expectations of securities analysts or investors, in which event our stock price would likely decline.

***Because we recognize revenue and expense relating to monthly subscriptions and professional services over varying periods, downturns or upturns in sales are not immediately reflected in full in our operating results.***

As a software-as-a-service, or SaaS, company, we recognize our subscription revenue monthly for the term of our contracts and recognize the majority of our professional services revenue ratably over the longer of the contract term or the estimated expected life of the customer relationship. As a result, a portion of the revenue we report each quarter is the recognition of deferred revenue from contracts we entered into during previous quarters. Consequently, a shortfall in demand for our software solutions and professional services or a decline in new or renewed contracts in any one quarter might not significantly reduce our revenue for that quarter, but could negatively affect our revenue in future quarters. Accordingly, the effect of significant downturns in new or renewed sales of our products and services is not reflected in full in our results of operations until future periods. Our revenue recognition model also makes it difficult for us to rapidly increase our revenue through additional sales in any period, because revenue from new customers must be recognized over the applicable term of the contracts or the estimated expected life of the customer relationship period. In addition, we recognize professional services expenses as incurred, which could cause professional services gross margin to be negative.

***We operate in a highly competitive industry, and if we are not able to compete effectively, our business and operating results will be harmed.***

The benefits management software market is highly competitive and is likely to attract increased competition, which could make it hard for us to succeed. Small, specialized providers continue to become more sophisticated and

effective. In addition, large, well-financed, and technologically sophisticated software companies might focus more on our market. The size and financial strength of these entities is increasing as a result of continued consolidation in both the IT and healthcare industries. We expect large integrated software companies to become more active in our market, both through acquisitions and internal investment. As costs fall and technology improves, increased market saturation might change the competitive landscape in favor of our competitors.

Some of our current large competitors have greater name recognition, longer operating histories, and significantly greater resources than we do. As a result, our competitors might be able to respond more quickly and effectively than we can to new or changing opportunities, technologies, standards, or customer requirements. In addition, current and potential competitors have established, and might in the future establish, cooperative relationships with vendors of complementary products, technologies, or services to increase the availability of their products in the marketplace. Accordingly, new competitors or alliances might emerge that have greater market share, a larger customer 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. Further, in light of these advantages, even if our products and services are more effective than those of our competitors, current or potential customers might accept competitive offerings in lieu of purchasing our offerings. Increased competition is likely to result in pricing pressures, which could negatively impact our sales, profitability, or market share. In addition to new niche vendors, who offer stand-alone products and services, we face competition from existing enterprise vendors, including those currently focused on software solutions that have information systems in place with potential customers in our target market. These existing enterprise vendors might promise products or services that offer ease of integration with existing systems and which leverage existing vendor relationships. In addition, large insurance carriers often have internal technology staffs and proprietary software for benefits management, making them less likely to buy our solutions.

---

**Table of Contents**

***The market for our products and services is immature and volatile, and if it does not develop or if it develops more slowly than we expect, the growth of our business will be harmed.***

The cloud-based benefits management software market is relatively new and unproven, and it is uncertain whether it will achieve and sustain high levels of demand and market acceptance. Our success will depend to a substantial extent on the willingness of employers, carriers, and consumers to increase their use of benefits management software. Many employers and carriers have invested substantial personnel and financial resources to integrate internally developed solutions or traditional enterprise software into their businesses for benefits management, and therefore might be reluctant or unwilling to migrate to our cloud-based solutions. Furthermore, some businesses might be reluctant to use cloud-based solutions because they have concerns about the security of their data and the reliability of the technology delivery model associated with these solutions. If employers, carriers and consumers do not perceive the benefits of our solutions, then our market might not develop at all, or it might develop more slowly than we expect, either of which could significantly adversely affect our operating results. In addition, we have limited insight into trends that might develop and affect our business. We might make errors in predicting and reacting to relevant business trends, which could harm our business. If any of these risks occur, it could materially adversely affect our business, financial condition or results of operations.

***The SaaS pricing model is evolving and our failure to manage its evolution and demand could lead to lower than expected revenue and profit.***

We derive most of our revenue growth from subscription offerings and, specifically, SaaS offerings. This business model depends heavily on achieving economies of scale because the initial upfront investment is costly and the associated revenue is recognized on a ratable basis. If we fail to achieve appropriate economies of scale or if we fail to manage or anticipate the evolution and demand of the SaaS pricing model, then our business and operating results could be adversely affected.

***If we do not continue to innovate and provide products and services that are useful to consumers, employers, insurance carriers, and brokers and provide high quality support services, we might not remain competitive, and our revenue and operating results could suffer.***

Our success depends in part on providing products and services that consumers, employers, insurance carriers, and brokers will use to manage benefits. We must continue to invest significant resources in research and development in order to enhance our existing products and services and introduce new high quality products and services that customers 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, we might lose customers. Our operating results would also suffer if our innovations are not responsive to the needs of our customers, are not appropriately timed with market opportunity, or are not effectively brought to market. As technology continues to develop, our competitors might be able to offer results that are, or that are perceived to be, substantially similar to or better than those generated by us. This would force us to compete on additional product and service attributes and to expend significant resources in order to remain competitive.

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.

Our success also depends on providing high quality support services to resolve any issues related to our products and services. High quality education and customer support is important for the successful marketing and sale of our

products and services and for the renewal of existing customers. If we do not help our customers quickly resolve issues and provide effective ongoing support, our ability to sell additional products and services to existing customers would suffer and our reputation with existing or potential customers would be harmed.

***If we are unable to retain our existing customers, our revenue and results of operations would be adversely affected.***

We sell our products and services pursuant to agreements that are generally one year for employers and three to five years for carriers. While our employer contracts generally automatically renew on an annual basis, our carrier customers have no obligation to renew their contracts after their contract period expires, and these contracts may not be renewed on the same or on more profitable terms if at all. Additionally, some of our carrier customers are able to terminate their respective contracts without cause or for convenience, although generally our carrier contracts are only cancellable by the carrier in an instance of our uncured breach. As a result, our ability to grow depends in part on the continuance and renewal of our carrier contracts. We may not be able to accurately predict future trends in customer renewals, and our customers' renewal rates may decline or fluctuate because of several factors, including their level of satisfaction or dissatisfaction with our services, the cost of our services, the cost of services offered by our competitors, or reductions in our customers' spending levels. If our carrier customers terminate or do not renew their contracts for our services, renew on less favorable terms, or do not purchase additional functionality or products, our revenue may grow more slowly than expected or decline, and our profitability and gross margins may be harmed.

***A significant amount of our revenue is derived from our largest customers, and any reduction in revenue from any of these customers would reduce our revenue and net income.***

Our ten largest customers by revenue in the past three years accounted for approximately 47.4%, 58.6% and 64.1% of our consolidated revenue in each of 2013, 2012 and 2011, respectively. Our largest customer by revenue in the past three years accounted for approximately 9.5%, 10.5% and 11.7% of our revenue in each of 2013, 2012 and 2011, respectively. If any of our key customers decides not to renew its contracts with us, or to renew on less favorable terms, our business, revenues, reputation, and our ability to obtain new customers could be materially and adversely affected.

## **Table of Contents**

***If the number of individuals covered by our employer and carrier customers decreases or the number of products or services to which our employer and carrier customers subscribe decreases, our revenue will decrease.***

Under most of our customer contracts, we base our fees on the number of individuals to whom our customers provide benefits and the number of products or services subscribed to by our customers. Many factors may lead to a decrease in the number of individuals covered by our customers and the number of products or services subscribed to by our customers, including:

failure of our customers to adopt or maintain effective business practices;

changes in the nature or operations of our customers;

government regulations; and

increased competition or other changes in the benefits marketplace.

If the number of individuals covered by our customers or the number of products or services subscribed to by our customers decreases for any reason, our revenue will likely decrease.

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

We have been experiencing a period of rapid growth, which puts strain on our business. To manage this and our anticipated future growth effectively, we must continue to maintain and enhance our IT infrastructure, financial and accounting systems, and controls. We also must attract, train, and retain a significant number of qualified sales and marketing personnel, customer support personnel, professional services personnel, software engineers, technical personnel, and management personnel. Failure to effectively manage our rapid growth could lead us to over-invest or under-invest in development and operations, result in weaknesses in our infrastructure, systems, or controls, give rise to operational mistakes, losses, loss of productivity or business opportunities, and result in loss of employees and reduced productivity of remaining employees. Our growth could require significant capital expenditures and might divert financial resources from other projects such as the development of new products and services. 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. The quality of our products and services might suffer, which could negatively affect our reputation and harm our ability to retain and attract customers.

***Economic uncertainties or downturns in the general economy or the industries in which our customers operate could disproportionately affect the demand for our solutions and negatively impact our results of operations.***

General worldwide economic conditions have experienced a significant downturn, and market volatility and uncertainty remain widespread, making it extremely difficult for our customers and us to accurately forecast and plan future business activities. In addition, these conditions could cause our customers or prospective customers to decrease headcount, benefits, or HR budgets, which could decrease corporate spending on our products and services, resulting in delayed and lengthened sales cycles, a decrease in new customer acquisition, and/or loss of customers.

Furthermore, during challenging economic times, our customers may have difficulty gaining timely access to sufficient credit or obtaining credit on reasonable terms, which could impair their ability to make timely payments to us and adversely affect our revenue. If that were to occur, our financial results could be harmed. Further, challenging economic conditions might impair the ability of our customers to pay for the products and services they already have purchased from us and, as a result, our write-offs of accounts receivable could increase. We cannot predict the timing, strength, or duration of any economic slowdown or recovery. If the condition of the general economy or markets in which we operate worsens, our business could be harmed.

***We depend on our senior management team, and the loss of one or more key associates or an inability to attract and retain highly skilled associates could adversely affect our business.***

Our success depends largely upon the continued services of our key executive officers. We also rely on our leadership team in the areas of research and development, marketing, services, and general and administrative functions, and on mission-critical individual contributors in research and development. 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. The loss of one or more of our executive officers or key associates could have a serious adverse effect on our business.

To continue to execute our growth strategy, we also must attract and retain highly skilled personnel. Competition is intense for engineers with high levels of experience in designing and developing software and Internet-related services. We might not be successful in maintaining our unique culture and continuing to attract and retain qualified personnel. We have from time to time in the past experienced, and we expect to continue to experience in the future, difficulty in hiring and retaining highly skilled personnel with appropriate qualifications. The pool of qualified personnel with SaaS experience and/or experience working with the benefits market is limited overall and specifically in Charleston, South Carolina, where our principal office is located. In addition, many of the companies with which we compete for experienced personnel have greater resources than we have and are located in geographic areas, like Silicon Valley, that may attract more qualified technology workers.

---

**Table of Contents**

In addition, in making employment decisions, particularly in the Internet and high-technology industries, job candidates often consider the value of the stock options they are to receive in connection with their employment. Volatility in the price of our stock might, therefore, adversely affect our ability to attract or retain highly skilled personnel. Furthermore, the requirement to expense stock options might discourage us from granting the size or type of stock option awards that job candidates require to join our company. 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.

***If we fail to maintain awareness of our brand cost-effectively, our business might suffer.***

We believe that maintaining awareness of our brand in a cost-effective manner is critical to continuing the widespread acceptance of our existing solutions and is an important element in attracting new customers. Furthermore, we believe that the importance of brand recognition will increase as competition in our market increases. Successful promotion of our brand will depend largely on the effectiveness of our marketing efforts and on our ability to provide reliable and useful services at competitive prices. Our efforts to build and maintain our brand nationally have involved significant expenses. Brand promotion activities may not yield increased revenue, and even if they do, any increased revenue may not offset the expenses we incur in maintaining our brand. If we fail to successfully maintain our brand, or incur substantial expenses in an unsuccessful attempt to maintain our brand, we may fail to attract enough new customers or retain our existing customers to the extent necessary to realize a sufficient return on our brand-building efforts, and our business could suffer.

***Our growth depends in part on the success of our strategic relationships with third parties.***

In order to grow our business, we anticipate that we will continue to depend on our relationships with third parties, including our partner organizations, and technology and content providers. Identifying partners, and negotiating and documenting relationships with them, requires significant time and resources. Our competitors might be effective in providing incentives to third parties to favor their products or services or to prevent or reduce subscriptions to our products and services. In addition, acquisitions of our partners by our competitors could result in a decrease in the number of our current and potential customers, as our partners may no longer facilitate the adoption of our applications by potential customers. If we are unsuccessful in establishing or maintaining our relationships with third parties, our ability to compete in the marketplace or to grow our revenue could be impaired and our operating results may suffer. Even if we are successful, we cannot assure you that these relationships will result in increased customer use of our applications or increased revenue.

***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.***

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 the licensing of our software or sale of our services could result in substantial tax liabilities for past transactions and otherwise harm our business. For example, in the quarter ended September 30, 2014, New York gave us notice it is auditing us, and as a result we increased our sales tax reserve by \$0.3 million. 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, voluntarily engage state tax authorities in order to determine how to comply with their 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 customer contracts typically provide that our customers must pay all applicable sales and similar taxes. Nevertheless, our customers 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 software and services to our customers and might adversely affect our ability to retain existing customers or to gain new customers in the areas in which such taxes are imposed.



***We might not be able to utilize a significant portion of our net operating loss or other tax credit carryforwards, which could adversely affect our profitability.***

We have federal and state net operating loss carryforwards due to prior period losses, which if not utilized will begin to expire in 2022 for federal and state purposes. We also have South Carolina jobs tax credit and headquarters tax credit carryforwards, which if not utilized will begin to expire in 2020. These tax credit carryforwards could expire unused and be unavailable to offset future income tax liabilities, which could adversely affect our profitability.

In addition, under Section 382 of the Internal Revenue Code of 1986, as amended, or the Code, our ability to utilize net operating loss carryforwards or other tax attributes in any taxable year may be limited if we experience an ownership change . A Section 382 ownership change generally occurs if one or more stockholders or groups of stockholders who own at least 5% of our stock increase their ownership by more than 50 percentage points over their lowest ownership percentage within a rolling three-year period. Similar rules might apply under state tax laws. Future issuances of our stock could cause an ownership change . It is possible that an ownership change, or any future ownership change, could have a material effect on the use of our net operating loss carryforwards or other tax attributes, which could adversely affect our profitability.

---

**Table of Contents**

***We might be unable to adequately protect, and we might incur significant costs in enforcing, our intellectual property and other proprietary rights.***

Our success depends in part on our ability to enforce our intellectual property and other proprietary rights. We rely on a combination of trademark, trade secret, copyright, patent, and unfair competition laws, as well as license and access agreements and other contractual provisions, to protect our intellectual property and other proprietary rights. In addition, we attempt to protect our intellectual property and proprietary information by requiring employees and consultants to enter into confidentiality, noncompetition, and assignment of inventions agreements. Our attempts to protect our intellectual property might be challenged by others or invalidated through administrative process or litigation. While we have two U.S. and one Chinese patent granted and a number of applications pending, we might not be able to obtain meaningful patent protection for our software. In addition, if any patents are issued in the future, they might not provide us with any competitive advantages, or might be successfully challenged by third parties. Agreement terms that address non-competition are difficult to enforce in many jurisdictions and might not be enforceable in certain cases. To the extent that our intellectual property and other proprietary rights are not adequately protected, third parties might gain access to our proprietary information, develop and market products or services similar to ours, or use trademarks similar to ours, each of which could materially harm our business. Existing U.S. federal and state intellectual property laws offer only limited protection. Moreover, the laws of other countries in which we might in the future conduct operations or contract for services might afford little or no effective protection of our intellectual property. The failure to adequately protect our intellectual property and other proprietary rights could materially harm our business.

In addition, if we resort to legal proceedings to enforce our intellectual property rights or to determine the validity and scope of the intellectual property or other proprietary rights of others, the proceedings could be burdensome and expensive, even if we were to prevail. Any litigation that is necessary in the future could result in substantial costs and diversion of resources and could have a material adverse effect on our business, operating results or financial condition.

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

The software and Internet industries are characterized by the existence of a large number of patents, trademarks, and copyrights and by frequent litigation based on allegations of infringement or other violations of intellectual property rights. We have received in the past, and might receive in the future, communications from third parties claiming that we have infringed the intellectual property rights of others. Our technologies might not be able to withstand any third-party claims or rights against their use. Any intellectual property claims, with or without merit, could be time-consuming and expensive to resolve, divert management attention from executing our business plan, and require us to pay monetary damages or enter into royalty or licensing agreements. In addition, many of our contracts contain warranties with respect to intellectual property rights, and most require us to indemnify our clients for third-party intellectual property infringement claims, which would increase the cost to us of an adverse ruling on such a claim.

Moreover, any settlement or adverse judgment resulting from such a claim could require us to pay substantial amounts of money or obtain a license to continue to use the software or information that is the subject of the claim, or otherwise restrict or prohibit our use of it. We might not be able to obtain a license on commercially reasonable terms, if at all, from third parties asserting an infringement claim; we might not be able to develop alternative technology on a timely basis, if at all; and we might not be able to obtain a license to use a suitable alternative technology to permit us to continue offering, and our clients to continue using, our affected services. Accordingly, an adverse determination could prevent us from offering our services to others.

***Failure to adequately expand our direct sales force will impede our growth.***

We believe that our future growth will depend on the continued development of our direct sales force and its ability to obtain new customers and to manage our existing customer base. Identifying and recruiting qualified personnel and training them in the use of our software requires significant time, expense, and attention. It can take six months or longer before a new sales representative is fully trained and productive. Our business may be adversely affected if our efforts to expand and train our direct sales force do not generate a corresponding increase in revenues. In particular, if we are unable to hire and develop sufficient numbers of productive direct sales personnel or if new direct sales personnel are unable to achieve desired productivity levels in a reasonable period of time, sales of our products and services will suffer and our growth will be impeded.

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

---

**Table of Contents**

***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 associates. 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 reducing our operating results and leading analysts or potential investors to reduce their expectations of our performance, which could reduce the trading price of our stock.

***If we acquire companies or technologies in the future, they could prove difficult to integrate, disrupt our business, dilute stockholder value, and adversely affect our operating results and the value of our common stock.***

As part of our business strategy, we might acquire, enter into joint ventures with, or make investments in complementary companies, services, and technologies in the future. For example, in 2010, we acquired 100% of the net assets of Beninform Holdings, Inc., including its wholly owned subsidiary Benefit Informatics, Inc., and the intellectual property assets of BeliefNetworks, Inc. We spent considerable time, effort, and money pursuing these companies and successfully integrating them into our business. Acquisitions and investments involve numerous risks, including:

difficulties in identifying and acquiring products, technologies or businesses that will help our business;

difficulties in integrating operations, technologies, services and personnel;

diversion of financial and managerial resources from existing operations;

risk of entering new markets in which we have little to no experience; and

delays in customer purchases due to uncertainty and the inability to maintain relationships with customers of the acquired businesses.

If we fail to properly evaluate acquisitions or investments, we might not achieve the anticipated benefits of any such acquisitions, we might incur costs in excess of what we anticipate, and management resources and attention might be diverted from other necessary or valuable activities.

***Future sales to customers outside the United States or with international operations might expose us to risks inherent in international sales which, if realized, could adversely affect our business.***

An element of our growth strategy is to expand internationally. Operating in international markets requires significant resources and management attention and will subject us to regulatory, economic, and political risks that are different from those in the United States. Because of our limited experience with international operations, our international expansion efforts might not be successful in creating demand for our products and services outside of the United

States or in effectively selling our solutions in the international markets we enter. In addition, we will face risks in doing business internationally that could adversely affect our business, including:

the need to localize and adapt our solutions for specific countries, including translation into foreign languages and associated expenses;

data privacy laws which require that customer data be stored and processed in a designated territory;

difficulties in staffing and managing foreign operations;

different pricing environments, longer sales cycles and longer accounts receivable payment cycles and collections issues;

new and different sources of competition;

weaker protection for intellectual property and other legal rights than in the United States and practical difficulties in enforcing intellectual property and other rights outside of the United States;

laws and business practices favoring local competitors;

compliance challenges related to the complexity of multiple, conflicting and changing governmental laws and regulations, including employment, tax, privacy, and data protection laws and regulations;

increased financial accounting and reporting burdens and complexities;

restrictions on the transfer of funds;

adverse tax consequences; and

unstable regional economic and political conditions.

---

**Table of Contents**

If we denominate our international contracts in local currencies, fluctuations in the value of the U.S. dollar and foreign currencies might impact our operating results when translated into U.S. dollars.

**Risks Related to Our Products and Services Offerings**

***If our security measures are breached or fail, and unauthorized persons gain access to customers and consumers data, our products and services might be perceived as not being secure, customers and consumers might curtail or stop using our products and services, and we might incur significant liabilities.***

Our products and services involve the storage and transmission of customers and consumers confidential information, which may include sensitive individually identifiable information that is subject to stringent legal and regulatory obligations. Because of the sensitivity of this information, security features of our software are very important. If our security measures are breached or fail and/or are bypassed as a result of third-party action, employee error, malfeasance, or otherwise, someone might be able to obtain unauthorized access to our customers confidential information and/or patient data. As a result, our reputation could be damaged, our business might suffer, information might be lost, and we could face damages for contract breach, penalties for violation of applicable laws or regulations, and significant costs for remediation and remediation efforts to prevent future occurrences.

In addition, we rely on various third parties, including employers HR departments, carriers, and other third-party service providers and consumers themselves, as users of our system for key activities to protect and promote the security of our systems and the data and information accessible within them, such as administration of enrollment, consumer status changes, claims, and billing. On occasion, people have failed to perform these activities. For example, employers sometimes have failed to terminate the login/password of former employees, or permitted current employees to share login/passwords. When we become aware of such breaches, we work with employers to terminate inappropriate access and provide additional instruction in order to avoid the reoccurrence of such problems. Although to date these breaches have not resulted in claims against us or in material harm to our business, failures to perform these activities might result in claims against us, which could expose us to significant expense, legal liability, and harm to our reputation, which might result in loss of business.

Because techniques used to obtain unauthorized access or to sabotage systems change frequently and generally are not recognized until launched against a target, we might not be able to anticipate these techniques or to implement adequate preventive measures. If an actual or perceived breach of our security occurs, the market perception of the effectiveness of our security measures could be harmed and we could lose sales and customers. Any significant violations of data privacy could result in the loss of business, litigation and regulatory investigations and penalties that could damage our reputation and adversely impact our results of operations and financial condition. In addition, our customers might authorize or enable third parties to access their information and data that is stored on our systems. Because we do not control such access, we cannot ensure the complete integrity or security of such data in our systems.

***Failure by our customers to obtain proper permissions and waivers might result in claims against us or may limit or prevent our use of data, which could harm our business.***

We require our customers to provide necessary notices and to obtain necessary permissions and waivers for use and disclosure of information on the Benefitfocus platform, and we require contractual assurances from them that they have done so and will do so. If, however, despite these requirements and contractual obligations, our customers do not obtain necessary permissions and waivers, then our use and disclosure of information that we receive from them or on their behalf might be limited or prohibited by state or federal privacy laws or other laws. This could impair our functions, processes and databases that reflect, contain, or are based upon such data and might prevent use of such

data. In addition, this could interfere with, or prevent creation or use of, rules, analyses, or other data-driven activities that benefit us and our business. Moreover, we might be subject to claims or liability for use or disclosure of information by reason of lack of valid notices, agreements, permissions or waivers. These claims or liabilities could subject us to unexpected costs and adversely affect our operating results.

***Our proprietary 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.***

Proprietary 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 proprietary applications from operating properly. If they do not function reliably or fail to achieve customer expectations in terms of performance, customers could assert liability claims against us and/or attempt to cancel their contracts with us. This could damage our reputation and impair our ability to attract or maintain customers.



Moreover, benefits management software as complex as ours has in the past contained, and may in the future contain, or develop, undetected defects or errors. Material performance problems or defects in our products and services might arise in the future. Errors might result from the interface of our services with legacy systems and data, which we did not develop and the function of which is outside of our control. Defects or errors might arise in our existing or new software or service processes. Because changes in employer, carrier, and legal requirements and practices relating to benefits are frequent, we are continuously discovering defects and errors in our software and service processes compared against these requirements and practices. Undiscovered vulnerabilities could expose our software to unscrupulous third parties who develop and deploy software programs that could attack our software or result in unauthorized access to customer data. Defects and errors and any failure by us to identify and address them could result in loss of revenue or market share, liability to customers or others, failure to achieve market acceptance or expansion, diversion of development

---

**Table of Contents**

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 customers from purchasing services 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.

In addition, customers that rely on our products and services to collect, manage, and report benefits data might have a greater sensitivity to service errors and security vulnerabilities than customers of software products in general. We market and sell services that, among other things, provide information to assist care providers in tracking and treating ill patients. Any operational delay in or failure of our software service processes might result in the disruption of patient care and could cause harm to our business and operating results.

Our customers 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 or 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.

***Various events could interrupt customers' access to the Benefitfocus platform, exposing us to significant costs.***

The ability to access the Benefitfocus platform is critical to our customers. Our operations and facilities are vulnerable to interruption and/or damage from a number of sources, many of which are beyond our control, including, without limitation: (i) power loss and telecommunications failures, (ii) fire, flood, hurricane, and other natural disasters, (iii) software and hardware errors, failures or crashes in our own systems or in other systems, (iv) computer viruses, denial-of-service attacks, hacking and similar disruptive problems in our own systems and in other systems, and (v) civil unrest, war, and/or terrorism. We have implemented various measures to protect against interruptions of customers' access to our platform. If customers' access is interrupted because of problems in the operation of our facilities, we could be exposed to significant claims by customers, particularly if the access interruption is associated with problems in the timely delivery of funds due to customers or medical information relevant to patient care. Our plans for disaster recovery and business continuity rely on third-party providers of related services. If those vendors fail us at a time when our systems are not operating correctly, we could incur a loss of revenue and liability for failure to fulfill our obligations. Any significant instances of system downtime could negatively affect our reputation and ability to retain customers and sell our services, which would adversely impact our revenue.

In addition, retention and availability of patient care and physician reimbursement data are subject to federal and state laws governing record retention, accuracy, and access. Some laws impose obligations on our customers and on us to produce information for third parties and to amend or expunge data at their direction. Our failure to meet these obligations might result in liability, which could increase our costs and reduce our operating results.

***We rely on data center providers, Internet infrastructure, bandwidth providers, third-party computer hardware and software, other third parties, and our own systems for providing services to our customers, and any failure or interruption in the services provided by these third parties or our own systems could expose us to litigation and negatively impact our relationships with customers, adversely affecting our brand and our business.***

We serve all our customers from two data centers, one located in Raleigh, North Carolina and the other located in Charlotte, North Carolina. While we control and have access to our servers, we do not control the operation of these facilities. The owners of our data center facilities have no obligation 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 one of our data center operators is acquired, we may be required to transfer our servers and other

infrastructure to new data center facilities, and we may incur significant costs and possible service interruption in connection with doing so. Problems faced by our third-party 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 customers, including us, could adversely affect the experience of our customers. Our third-party data centers operators could decide to close their facilities without adequate notice. In addition, any financial difficulties, such as bankruptcy faced by our third-party data centers operators 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.

In addition, our ability to deliver our web-based services depends on the development and maintenance of the infrastructure of the Internet 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 in accordance with our service level commitments. 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 customers. To operate without interruption, both we and our service providers 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.

---

**Table of Contents**

We also rely on computer hardware purchased or leased and software licensed from third parties in order to offer our services, including software from Oracle Corporation and Microsoft Corporation, and routers and network equipment from Cisco and Hewlett-Packard Company. These licenses 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.

We exercise limited control over third-party vendors, which increases our vulnerability to problems with technology and information services they provide. Interruptions in our network access and services might in connection with third-party technology and information services reduce our revenue, cause us to issue refunds to customers for prepaid and unused subscription services, subject us to potential liability, or adversely affect our renewal rates. Although we maintain insurance for our business, the coverage under our policies might not be adequate to compensate us for all losses that may occur. In addition, we might not be able to continue to obtain adequate insurance coverage at an acceptable cost, if at all.

***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.

**Risks Related to Regulation**

***Government regulation of the areas in which we operate creates risks and challenges with respect to our compliance efforts and our business strategies.***

The employee benefits industry is highly regulated and is subject to changing political, legislative, regulatory, and other influences. Existing and new laws and regulations affecting the employee benefits industry could create unexpected liabilities for us, cause us to incur additional costs and restrict our operations. These laws and regulations are complex and their application to specific services and relationships are not clear. In particular, many existing laws and regulations affecting employee benefits, when enacted, did not anticipate the services that we provide, and these laws and regulations might be applied to our services in ways that we do not anticipate. Our failure to accurately anticipate the application of these laws and regulations, or our failure to comply, could create liability for us, result in adverse publicity, and negatively affect our business. Some of the risks we face from the regulation of employee benefits are as follows:

*PPACA.* Governmental oversight punctuated with the passage of the Patient Protection and Affordable Care Act, or PPACA, has led to an increasingly intricate regulatory framework under which health benefits are delivered, accessed, and maintained. Although many of the provisions of PPACA do not directly apply to us, PPACA might affect the business of many of our customers. Carriers and large employers might experience changes in the numbers of individuals they insure as a result of Medicaid expansion and the creation of state and national exchanges, though it is unclear how many states will decline to implement the Medicaid expansion or adopt state-specific exchanges. Although we are unable to predict with any reasonable certainty or otherwise quantify the likely impact of PPACA on our business model, financial condition, or results of operations, changes in the business of our customers and the number of individuals they insure may negatively impact our business. Moreover, Congress has repeatedly but unsuccessfully attempted to repeal PPACA and we are unable to predict the impact.

*False or Fraudulent Claim Laws.* There are numerous federal and state laws that forbid submission of false information or the failure to disclose information in connection with submission and payment of claims for reimbursement from the government. In some cases, these laws also forbid abuse of existing systems for such submission and payment. Although our business operations are generally not subject to these laws and regulations, any contract we have with a government entity requires us to comply with these laws and regulations. Any failure of

**Table of Contents**

our services to comply with these laws and regulations could result in substantial liability, including but not limited to criminal liability, could adversely affect demand for our services, and could force us to expend significant capital, research and development, and other resources to address the failure. Any determination by a court or regulatory agency that our services with government clients violate these laws and regulations could subject us to civil or criminal penalties, invalidate all or portions of some of our government client contracts, require us to change or terminate some portions of our business, require us to refund portions of our services fees, cause us to be disqualified from serving not only government clients but also all clients doing business with government payers, and have an adverse effect on our business.

*HIPAA and Other Privacy and Security Requirements.* There are numerous U.S. federal and state laws and regulations related to the privacy and security of personal health information. In particular, regulations promulgated pursuant to the Health Insurance Portability and Accountability Act of 1996, or HIPAA, established privacy and security standards that limit the use and disclosure of individually identifiable health information, and require the implementation of administrative, physical, and technological safeguards to ensure the confidentiality, integrity, and availability of individually identifiable health information in electronic form. Health plans, healthcare clearinghouses, and most providers are considered by the HIPAA regulations to be Covered Entities. With respect to our operations as a healthcare clearinghouse, we are directly subject to the privacy regulations established under HIPAA, or Privacy Standards, and the security regulations established under HIPAA, or Security Standards. In addition, our carrier customers, or payors, are considered to be Covered Entities and are required to enter into written agreements with us, known as Business Associate Agreements, under which we are considered to be a Business Associate and that require us to safeguard individually identifiable health information and restrict how we may use and disclose such information. The American Recovery and Reinvestment Act of 2009, or ARRA, and the HIPAA Omnibus Final Rules extended the direct application of certain provisions of the Privacy Standards and Security Standards to us when we are functioning as a Business Associate of our carrier customers. ARRA and the HIPAA Omnibus Final Rule also subject Business Associates to direct oversight and audit by the U.S. Department of Health and Human Services.

Violations of the Privacy Standards and Security Standards might result in civil and criminal penalties, and ARRA increased the penalties for HIPAA violations and strengthened the enforcement provisions of HIPAA. For example, ARRA authorizes state attorneys general to bring civil actions seeking either injunctions or damages in response to violations of Privacy Standards and Security Standards that threaten the privacy of state residents.

We might not be able to adequately address the business risks created by HIPAA implementation. Furthermore, we are unable to predict what changes to HIPAA or other laws or regulations might be made in the future or how those changes could affect our business or the costs of compliance.

Some payors and clearinghouses interpret HIPAA transaction requirements differently than we do. Where payors or clearinghouses require conformity with their interpretations as a condition of a successful transaction, we seek to comply with their interpretations.

In addition to the Privacy Standards and Security Standards, most states have enacted patient confidentiality laws that protect against the disclosure of confidential medical and/or health information, and many states have adopted or are considering further legislation in this area, including privacy safeguards, security standards, and data security breach notification requirements. Such state laws, if more stringent than HIPAA requirements, are not preempted by the federal requirements and we are required to comply with them.

Failure by us to comply with any state standards regarding patient privacy may subject us to penalties, including civil monetary penalties and, in some circumstances, criminal penalties. Such failure may injure our reputation and adversely affect our ability to retain customers and attract new customers.

*Medicare and Medicaid Regulatory Requirements.* We have contracts with insurance carriers who offer Medicare Managed Care (also known as Medicare Advantage or Medicare Part C) and Medicaid Managed Care benefits plans. We also have contracts with insurance carriers who offer Medicare prescription drug benefits (also known as Medicare Part D) plans. The activities of the Medicare plans are regulated by the Centers for Medicare & Medicaid Services, or CMS, the federal agency that provides oversight of the Medicare and Medicaid programs. The Medicaid Managed Care plans are regulated by both CMS and the individual states where the plans are offered. Some of the activities that we might perform, such as the enrollment of beneficiaries, may be subject to CMS and/or state regulation, and such regulations may force us to change the way we do business or otherwise restrict our ability to provide services to such plans. Moreover, the regulatory environment with respect to these programs has become, and will likely continue to become, increasingly complex.

*Financial Services-Related Laws and Rules.* Financial services and electronic payment processing services are subject to numerous laws, regulations and industry standards, some of which might impact our operations and subject us, our vendors, and our customers to liability as a result of the payment distribution and processing solutions we offer. Although we do not act as a bank, we offer solutions that involve banks, or vendors who contract with banks and other regulated providers of financial services. As a result, we might be impacted by banking and financial services industry laws, regulations, and industry standards, such as licensing requirements, solvency standards, requirements to maintain the privacy and security of nonpublic personal financial information, and Federal Deposit Insurance Corporation deposit insurance limits. In addition, our patient billing and payment distribution and

**Table of Contents**

processing solutions might be impacted by payment card association operating rules, certification requirements, and rules governing electronic funds transfers. If we fail to comply with applicable payment processing rules or requirements, we might be subject to fines and changes in transaction fees and may lose our ability to process credit and debit card transactions or facilitate other types of billing and payment solutions. Moreover, payment transactions processed using the Automated Clearing House Network, or ACH, are subject to network operating rules promulgated by the National Automated Clearing House Association and to various federal laws regarding such operations, including laws pertaining to electronic funds transfers, and these rules and laws might impact our billing and payment solutions. Further, our solutions might impact the ability of our payor customers to comply with state prompt payment laws. These laws require payors to pay healthcare claims meeting the statutory or regulatory definition of a clean claim within a specified time frame.

*Insurance Broker Laws.* Insurance laws in the United States are often complex, and states have broad authority to adopt regulations regarding brokerage activities. These regulations typically include the licensing of insurance brokers and agents and govern the handling and investment of client funds held in a fiduciary capacity. Although we believe our activities do not currently constitute the provision of insurance brokerage services, regulations may change from state to state, which could require us to comply with such expanded regulation.

*ERISA.* The Employee Retirement Income Security Act of 1974, as amended, or ERISA, regulates how employee benefits are provided to or through certain types of employer-sponsored health benefits plans. ERISA is a set of laws and regulations that is subject to periodic interpretation by the U.S. Department of Labor as well as the federal courts. In some circumstances, and under certain customer contracts, we might be deemed to have assumed duties that make us an ERISA fiduciary, and thus be required to carry out our operations in a manner that complies with ERISA in all material respects. We believe that our current operations do not render us subject to ERISA fiduciary obligations, and therefore that we are in material compliance with ERISA and that any such compliance does not currently have a material adverse effect on our operations. However, there can be no assurance that continuing ERISA compliance efforts or any future changes to ERISA will not have a material adverse effect on us.

*Third-Party Administrator Laws.* Numerous states in which we do business have adopted regulations governing entities engaged in third-party administrator, or TPA, activities. TPA regulations typically impose requirements regarding enrollment into benefits plans, claims processing and payments, and the handling of customer funds. Although we do not believe we are currently acting as a TPA, changes in state regulations could result in us being obligated to comply with such regulations, which might require us to obtain licenses to provide TPA services in such states.

***We are subject to banking regulations that may limit our business activities.***

The Goldman Sachs Group, affiliates of which owned approximately 33.4% of the voting and economic interest in our business at September 30, 2014, is regulated as a bank holding company and a financial holding company under the Bank Holding Company Act of 1956, as amended, or the BHC Act. The BHC Act imposes regulations and requirements on The Goldman Sachs Group and on any company that is deemed to be controlled by The Goldman Sachs Group under the BHC Act and the regulations of the Board of Governors of the Federal Reserve System, or the Federal Reserve. Due to the size of its voting and economic interest, we are deemed to be controlled by The Goldman Sachs Group and are therefore considered to be a subsidiary of The Goldman Sachs Group under the BHC Act. We



will remain subject to this regulatory regime until The Goldman Sachs Group is no longer deemed to control us for purposes of the BHC Act, which we do not generally have the ability to control and which will not occur until The Goldman Sachs Group has significantly reduced its voting and economic interest in us.

As a controlled subsidiary of The Goldman Sachs Group, we are restricted from engaging in activities that are not permissible under the BHC Act, or the rules and regulations promulgated thereunder. Permitted activities for a bank holding company or any controlled subsidiary generally include activities that the Federal Reserve has previously determined to be closely related to banking, financial in nature or incidental or complementary to financial activities, including data processing services such as those that we provide with our software solutions. Restrictions placed on The Goldman Sachs Group as a result of supervisory or enforcement actions under the BHC Act or otherwise may restrict us or our activities in certain circumstances, even if these actions are unrelated to our conduct or business. Further, as a result of being subject to regulation and supervision by the Federal Reserve, we may be required to obtain the prior approval of the Federal Reserve before engaging in certain new activities or businesses, whether organically or by acquisition. The Federal Reserve could exercise its power to restrict us from engaging in any activity that, in the Federal Reserve's opinion, is unauthorized or constitutes an unsafe or unsound business practice. To the extent that these regulations impose limitations on our business, we could be at a competitive disadvantage because some of our competitors are not subject to these limitations.

Additionally, any failure of The Goldman Sachs Group to maintain its status as a financial holding company could result in further limitations on our activities and our growth. In particular, our permissible activities could be restricted to only those that constitute banking or activities closely related to banking. The Goldman Sachs Group's loss of its financial holding company status could be caused by several factors, including any failure by The Goldman Sachs Group's bank subsidiaries to remain sufficiently capitalized, by any examination downgrade of one of The Goldman Sachs Group's bank subsidiaries, or by any failure of one of The Goldman Sachs Group's bank subsidiaries to maintain a satisfactory rating under the Community Reinvestment Act. In addition, the Dodd-Frank Wall Street Reform and Consumer Protection Act, or Dodd-Frank Act, broadened the requirements for maintaining financial holding company status by also requiring the holding company to remain well capitalized and well managed. We have no ability to prevent such occurrences from happening.

---

**Table of Contents**

As a subsidiary of a bank holding company, we are subject to examination by the Federal Reserve and required to provide information and reports for use by the Federal Reserve under the BHC Act. In addition, we may be subject to regulatory oversight and examination because we are a technology service provider to regulated financial institutions. The Federal Reserve may also impose substantial fines and other penalties for violations of applicable banking laws, regulations and orders. Further, the Dodd-Frank Act, including Title VI thereunder known as the Volcker Rule, and related financial regulatory reform call for the issuance of numerous regulations designed to increase and strengthen the regulation of bank holding companies, including The Goldman Sachs Group and its affiliates. U.S. financial regulators approved the final rules to implement the Volcker Rule in December 2013. The Volcker Rule, in relevant part, restricts banking entities from proprietary trading (subject to certain exemptions) and from acquiring or retaining any equity, partnership or other interests in, or sponsoring, a private equity fund, subject to satisfying certain conditions, and from engaging in certain transactions with funds.

We have agreed to certain covenants for the benefit of The Goldman Sachs Group that are intended to facilitate its compliance with the BHC Act, but that may impose certain obligations on our company. In particular, The Goldman Sachs Group has rights to conduct audits on, and access certain information of, our company and certain rights to review the policies and procedures that we implement to comply with the laws and regulations that relate to our activities. In addition, we are obligated to provide The Goldman Sachs Group with notice of certain events and business activities and cooperate with The Goldman Sachs Group to mitigate potential adverse consequences resulting therefrom.

***Potential regulatory requirements placed on our software, services, and content could impose increased costs on us, delay or prevent our introduction of new service types, and impair the function or value of our existing service types.***

Our products and services are and are likely to continue to be subject to increasing regulatory requirements in a number of ways. As these requirements proliferate, we must change or adapt our products and services to comply. Changing regulatory requirements might render our services obsolete or might block us from accomplishing our work or from developing new 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 product or service types 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 unprofitable or impossible.

***Potential government subsidy of services similar to ours, or creation of a single payor system, might reduce customer demand.***

Recently, entities including brokers and U.S. federal and state governments have offered to subsidize adoption of online benefits platforms or clearinghouses. In addition, federal regulations have been changed to permit such subsidy from additional sources subject to certain limitations. To the extent that we do not qualify or participate in such subsidy programs, demand for our services might be reduced, which may decrease our revenue. In addition, prior proposals regarding healthcare reform have included the concept of creation of a single payor for healthcare insurance. This kind of consolidation of critical benefits activity could negatively impact the demand for our services.

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

Among other things, certain services offered by us involve collecting payment information from individuals, and this frequently includes check and credit card information. Even though we do not handle direct payments, 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.

### **Risks Related to Ownership of Our Common Stock**

*Our stock price may be volatile or may decline regardless of our operating performance, and you may not be able to resell your shares at or above the price at which you purchase it.*

The stock market historically has experienced extreme price and volume fluctuations. As a result of this volatility, you might not be able to sell your common stock at or above the price at which you purchase it. The public market for our stock is very new. From our IPO in September 2013 through October 31, 2014, the per share trading price of our common stock has been as high as \$77.00 and as low as \$20.82. It might continue to fluctuate significantly in response to various factors, some of which are beyond our control. These factors include:

our operating performance and the operating performance of similar companies;

the overall performance of the equity markets;

announcements by us or our competitors of acquisitions, business plans, or commercial relationships;

threatened or actual litigation;

changes in laws or regulations relating to the sale of health insurance;

## **Table of Contents**

any major change in our board of directors or management;

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;

large volumes of sales of our shares of common stock by existing stockholders; and

general political and economic conditions.

In addition, the stock market in general, and the market for Internet-related companies in particular, has experienced extreme price and volume fluctuations that have often been unrelated or disproportionate to the operating performance of those companies. These fluctuations might be even more pronounced in the relatively new trading market for our stock. Additionally, 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 never declared or paid any cash dividends on our common stock 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.

***Our stock price could decline due to the large number of outstanding shares of our common stock eligible for future sale.***

Sales of a substantial number of shares of our common stock in the public market or the market perception that the holder or holders of a large number of shares intend to sell shares, could reduce the market price of our common stock. These sales could also make it more difficult for us to sell equity or equity-related securities in the future at a time and price that we deem appropriate.

As of September 30, 2014, we had an aggregate of 25,552,595 shares of common stock outstanding. Of these shares, approximately 15,649,749 shares became eligible for sale on October 14, 2014, upon the expiration of lock-up agreements with the underwriters for our secondary offering, subject in some cases to volume and other restrictions of Rule 144 under the Securities Act. As of September 30, 2014, there were outstanding options and restricted stock units to purchase 2,905,060 shares of our common stock that, if exercised or vested, as applicable, will result in these additional shares becoming available for sale subject in some cases to Rule 144. On November 12, 2013, we also registered an aggregate of 6,249,766 shares of our common stock that we may issue under our stock plans. These shares can be freely sold in the public market upon issuance, unless they are held by affiliates, as that term is defined in Rule 144 of the Securities Act. If a large number of these shares are sold in the public market, the sales could reduce the trading price of our common stock.

***We have broad discretion in the use of the net proceeds we received from our IPO and might not use them effectively.***

Our management has broad discretion to use the net proceeds from our IPO, and you will be relying on the judgment of our management regarding the application of these proceeds. Our management might not apply the net proceeds of IPO in ways that increase the value of your investment. Until we use the net proceeds from our IPO, we plan to invest them, and these investments may not yield a favorable rate of return. If we do not invest or apply the net proceeds from our IPO in ways that enhance stockholder value, we may fail to achieve expected financial results, which could cause our stock price to decline.

***A limited number of stockholders will have the ability to influence the outcome of director elections and other matters requiring stockholder approval.***

As of September 30, 2014, our directors, executive officers, and their affiliated entities beneficially owned more than 60% of our outstanding common stock. In particular, GS Capital Partners VI Parallel, L.P., GS Capital Partners VI Offshore Fund, L.P., GS Capital Partners VI Fund, L.P., and GS Capital Partners VI GmbH & CO. KG, which are affiliates of Goldman, Sachs & Co. and which we refer to as the Goldman Funds, collectively beneficially owned approximately 33.4%. These stockholders, if they act together, could exert substantial influence over matters requiring approval by our stockholders, including the amendment of our certificate of incorporation and bylaws, and the approval of mergers or other business combination transactions.

Additionally, the Goldman Funds, Oak Investment Partners XII, L.P., Mason R. Holland, Jr., our Executive Chairman and a director, and Shawn A. Jenkins, our President and Chief Executive Officer and a director, entered into a voting agreement for the election of directors. As of September 30, 2014, these stockholders will collectively beneficially own more than 60% of our common stock. Pursuant to the voting agreement, the parties agree to vote all of their shares to elect two directors nominated by the Goldman Funds, one director nominated by Oak Investment Partners, and each of Messrs. Holland and Jenkins to our board of directors. As a result, these stockholders will have significant influence on the outcome of director elections. This concentration of ownership might discourage, delay, or prevent a change in control of our company, which could deprive our stockholders of an opportunity to receive a premium for their stock as part of a sale of our company and might reduce our stock price. These actions may be taken even if they are opposed by other stockholders.

---

**Table of Contents**

***We are a controlled company within the meaning of the NASDAQ Stock Market listing rules, and take advantage of exemptions from certain corporate governance requirements.***

As of September 30, 2014, more than 60% of the voting power of our outstanding common stock was beneficially owned by a group of our significant stockholders consisting of Oak Investment Partners XII, L.P., the Goldman Funds, and Messrs. Holland and Jenkins. Under the NASDAQ Stock Market listing rules, a company of which more than 50% of the voting power is held by an individual, group or another company is a controlled company and is exempt from the corporate governance requirements that a majority of our directors be independent, as defined in the NASDAQ Stock Market listing rules, and that our compensation and nominating and corporate governance committees consist entirely of independent directors. We currently rely on the controlled company exemption under the NASDAQ Stock Market listing rules. While a majority of the members of our board of directors and all of the members of our compensation committee are independent directors, our nominating and corporate governance committee does not consist entirely of independent directors. Accordingly, while we remain a controlled company and during any transition period following a time when we are no longer a controlled company, you will not have the same protections afforded to stockholders of companies that are subject to all of the NASDAQ Stock Market's corporate governance requirements.

***Provisions in our restated certificate of incorporation and amended and restated bylaws and Delaware law might discourage, delay, or prevent a change in control of our company or changes in our management and, therefore, depress the trading price of our common stock.***

Provisions of our certificate of incorporation and bylaws and Delaware law might discourage, delay, or prevent a merger, acquisition, or other change in control that stockholders consider favorable, including transactions in which you might otherwise receive a premium for your shares of our common stock. These provisions might also prevent or frustrate attempts by our stockholders to replace or remove our management. These provisions include:

limitations on the removal of directors;

advance notice requirements for stockholder proposals and nominations;

limitations on the ability of stockholders to call special meetings;

The Goldman Sachs Group and its affiliates cease to own at least 35% of our voting equity, the inability of stockholders to act by written consent;

the inability of stockholders to cumulate votes at any election of directors;

the classification of our board of directors into three classes with only one class, representing approximately one-third of our directors, standing for election at each annual meeting; and



the ability of our board of directors to make, alter or repeal our bylaws.

Our Board of Directors has the ability to designate the terms of and issue new series of preferred stock without stockholder approval. In addition, Section 203 of the Delaware General Corporation Law prohibits a publicly held Delaware corporation from engaging in a business combination with an interested stockholder, generally a person which together with its affiliates owns, or within the last three years has owned, 15% of our voting stock, for a period of three years after the date of the transaction in which the person became an interested stockholder, unless the business combination is approved in a prescribed manner.

The existence of the foregoing provisions and anti-takeover measures could limit the price that investors are willing to pay in the future for shares of our common stock. They could also deter potential acquirers of our company, thereby reducing the likelihood that you could receive a premium for your common stock in an acquisition.

***Our business is subject to changing regulations regarding corporate governance, disclosure controls, internal control over financial reporting, and other compliance areas that will increase both our costs and the risk of noncompliance.***

As a public company, we are subject to the reporting requirements of the Securities Exchange Act of 1934, or the Exchange Act, the Sarbanes-Oxley Act of 2002, or the Sarbanes-Oxley Act, the Dodd-Frank Act, and the rules and regulations of our stock exchange. The requirements of these rules and regulations will increase our legal, accounting, and financial compliance costs, will make some activities more difficult, time-consuming, and costly, and may also place undue strain on our personnel, systems, and resources.

The Sarbanes-Oxley Act requires, among other things, that we maintain effective disclosure controls and procedures and internal control over financial reporting. Commencing with our fiscal year ending December 31, 2014, we must perform system and process evaluation and testing of our internal control over financial reporting to allow management to report on the effectiveness of our internal control over financial reporting, as required by Section 404 of the Sarbanes-Oxley Act. Our compliance with Section 404 of the Sarbanes-Oxley Act will require that we incur substantial accounting expense and expend significant management efforts. Prior to our IPO, we had never been required to test our internal controls within a specified period, and, as a result, we may experience difficulty in meeting these reporting requirements in a timely manner.

**Table of Contents**

We are required to disclose changes made to our internal control and procedures on a quarterly basis. However, our independent registered public accounting firm will not be required to formally attest to the effectiveness of our internal control over financial reporting pursuant to Section 404 of the Sarbanes-Oxley Act until the later of the year following our first annual report required to be filed with the SEC or the date we are no longer an emerging growth company as defined in the Jumpstart Our Business Startups Act of 2012, or the JOBS Act, if we take advantage of the exemption available under the JOBS Act to the auditor attestation requirement in Section 404(b) of the Sarbanes-Oxley Act. If we are not able to comply with the requirements of Section 404 of the Sarbanes-Oxley Act in a timely manner, the market price of our stock could decline and we could be subject to sanctions or investigations by the stock exchange on which our common stock is listed, the SEC, or other regulatory authorities, which would require additional financial and management resources.

***Failure to develop and maintain adequate financial controls could cause us to have material weaknesses, which could adversely affect our operations and financial position.***

As previously reported, in the first quarter of 2014, we identified a material weakness in internal controls over the accounting for leasing transactions which resulted in the identification of a material error in the accounting for our headquarters lease executed in May 2005. We might in the future discover other material weaknesses that require remediation. In addition, an internal control system, no matter how well-designed, cannot provide absolute assurance that misstatements due to error or fraud will not occur or that all control issues and instances of fraud will be detected. If we are not able to comply with the requirements of Section 404 of the Sarbanes-Oxley Act in a timely manner, or if we are unable to maintain proper and effective internal controls, we might not be able to produce timely and accurate financial statements. If that were to happen, the market price of our stock could decline and we could be subject to sanctions or investigations by the stock exchange on which our common stock is listed, the SEC, or other regulatory authorities.

Any failure to develop or maintain effective controls, or any difficulties encountered in their implementation or improvement, could harm our operating results or cause us to fail to meet our reporting obligations. Any failure to implement and maintain effective internal controls also could adversely affect the results of periodic management evaluations regarding the effectiveness of our internal control over financial reporting that we will be required to include in our periodic reports filed with the SEC, beginning for our fiscal year ending December 31, 2014 under Section 404 of the Sarbanes-Oxley Act. Ineffective disclosure controls and procedures or internal control over financial reporting could also cause investors to lose confidence in our reported financial and other information, which would likely have a negative effect on the trading price of our common stock. Implementing any appropriate changes to our internal controls may require specific compliance training of our directors, officers, and employees, entail substantial costs in order to modify our existing accounting systems, and take a significant period of time to complete. Such changes may not be effective, however, in maintaining the adequacy of our internal controls, and any failure to maintain that adequacy, or consequent inability to produce accurate financial statements on a timely basis, could increase our operating costs and could materially impair our ability to operate our business. In the event that we are not able to demonstrate compliance with Section 404 of the Sarbanes-Oxley Act in a timely manner, that our internal controls are perceived as inadequate, or that we are unable to produce timely or accurate financial statements, investors may lose confidence in our operating results and our stock price could decline.

***We are an emerging growth company and we cannot be certain if the reduced disclosure requirements applicable to emerging growth companies will make our common stock less attractive to investors.***

We are an emerging growth company. Under the JOBS Act, emerging growth companies can delay adopting new or revised accounting standards until such time as those standards apply to private companies. We have irrevocably elected not to avail ourselves of this exemption from new or revised accounting standards and, therefore, we will be

subject to the same new or revised accounting standards as other public companies that are not emerging growth companies.

For as long as we continue to be an emerging growth company, we intend to take advantage of certain other exemptions from various reporting requirements that are applicable to other public companies including, but not limited to, reduced disclosure obligations regarding executive compensation in our periodic reports and proxy statements, exemptions from the requirements of holding a nonbinding advisory vote on executive compensation and stockholder approval of any golden parachute payments not previously approved, and exemptions from the requirements of auditor attestation reports on the effectiveness of our internal control over financial reporting. We cannot predict if investors will find our common stock less attractive because we will rely on these exemptions. If some investors find our common stock less attractive as a result, there may be a less active trading market for our common stock and our stock price may be more volatile.

We will remain an emerging growth company until the earliest of (i) the end of the fiscal year in which the market value of our common stock that is held by non-affiliates exceeds \$700 million as of June 30 of that fiscal year, (ii) the end of the fiscal year in which we have total annual gross revenue of \$1 billion or more during such fiscal year, (iii) the date on which we issue more than \$1 billion in non-convertible debt in a three-year period, or (iv) September 17, 2018.

***If securities or industry analysts do not publish research or reports about our business, or publish inaccurate or unfavorable research or reports about our business, our stock price and trading volume could decline.***

The trading market for our common stock depends, to some extent, on the research and reports that securities or industry analysts publish about us and our business. We do not have any control over these analysts. If one or more of the analysts who cover us downgrade our common stock or change their opinion of our common stock, our stock price would likely decline. If one or more of these analysts cease coverage of our company or fail to regularly publish reports on us, we could lose visibility in the financial markets, which could cause our stock price or trading volume to decline.

---

**Table of Contents**

**ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS**

**b. Use of Proceeds from Public Offering of Common Stock**

On September 17, 2013, our Registration Statement on Form S-1, (File No. 333-190610) was declared effective in connection with our IPO, pursuant to which 5,675,250 shares of common stock were registered, including the full exercise of the underwriters' over-allotment option. Of the shares registered, we sold 3,000,000 shares of common stock at a price to the public of \$26.50 per share for an aggregate price of \$79,500,000. Selling shareholders sold the remaining 2,675,250 shares registered at the same per share price for an aggregate price of \$70,894,000. The offering closed on September 23, 2013, and, as a result, we received net proceeds of \$70,064,000 (after underwriters' discounts and commissions of \$5,565,000 and additional offering related costs of \$3,871,000). The joint managing underwriters of the offering were Goldman Sachs & Co., Deutsche Bank Securities Inc. and Jefferies LLC.

Of the expenses incurred by us in connection with our IPO, \$134,000 were paid to or for the underwriters and \$52,000 were paid to a related party vendor for private air travel. This vendor is owned and controlled by the Executive Chairman of our board of directors, who is also a greater than 10% owner of our common stock.

There was no material change in the use of proceeds from our IPO as described in our final prospectus filed pursuant to Rule 424(b) of the Securities Act with the SEC on September 18, 2013. From the effective date of the registration statement through September 30, 2014, we have used the net proceeds from our IPO for working capital purposes and other general corporate purposes, including executing our growth strategy, developing new products and services, and funding additional capital expenditures, potential acquisitions, and investments. We have invested the funds received in short-term, interest bearing, investment-grade securities.

**Table of Contents****ITEM 6. EXHIBITS**

<b>Exhibit Number</b>	<b>Exhibit Title</b>	<b>Form</b>	<b>Incorporated by Reference (Unless Otherwise Indicated)</b>		
			<b>File</b>	<b>Exhibit</b>	<b>Filing Date</b>
2.1	Agreement and Plan of Merger, dated August 29, 2013 by and among Benefitfocus.com, Inc., Benefitfocus, Inc., and Benefitfocus Mergeco, Inc.	S-1/A	333-190610	2.1	September 5, 2013
3.1.3	Restated Certificate of Incorporation of Benefitfocus, Inc.	10-Q		3.1.3	November 12, 2013
3.2	Amended and Restated Bylaws of Benefitfocus, Inc.	S-1/A	333-190610	3.2	September 5, 2013
4.1	Specimen Certificate for Common Stock.	S-1/A	333-190610	4.1	September 5, 2013
4.3	Form of Second Amended and Restated Investors Rights Agreement, dated , 2013, by and among Benefitfocus, Inc. and certain stockholders named therein.	S-1/A	333-190610	4.3	September 16, 2013
10.2	Form of Second Amended and Restated Voting Agreement, dated , 2013, by and among Benefitfocus, Inc., and certain stockholders named therein.	S-1/A	333-190610	10.2	September 5, 2013
10.3	Amended and Restated 2000 Stock Option Plan.#	S-1	333-190610	10.3	August 14, 2013
10.4	2012 Stock Plan, as amended.#	S-1/A	333-190610	10.4	September 5, 2013
10.5	Form of Grant Notice and Stock Option Agreement under the Amended and Restated 2000 Stock Option Plan.#	S-1	333-190610	10.5	August 14, 2013
10.6	Form of Grant Notice and Stock Option Agreement under the 2012 Stock Plan, as amended.#	S-1	333-190610	10.6	August 14, 2013
10.7	Form of Management Incentive Bonus Program.#	S-1	333-190610	10.7	August 14, 2013
10.11	Form of Employment Agreement.#	S-1	333-190610	10.11	August 14, 2013
10.12	Form of Indemnification Agreement.#	S-1	333-190610	10.12	August 14, 2013
31.1	Certification of the President and Chief Executive Officer pursuant to Section 302 of				Filed herewith

the Sarbanes-Oxley Act of 2002.

31.2	Certification of the Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.	Filed herewith
32.1	Certification of the President and Chief Executive Officer, and the Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.	Filed herewith
101.INS	XBRL Instance Document.	Furnished herewith
101.SCH	XBRL Taxonomy Extension Schema Document.	Furnished herewith
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document.	Furnished herewith
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document.	Furnished herewith
101.LAB	XBRL Taxonomy Extension Label Linkbase Document.	Furnished herewith
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document.	Furnished herewith

# Management contract or compensatory plan.

**Table of Contents**

**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.

Date: November 7, 2014

Benefitfocus, Inc.

By: /s/ Milton A. Alpern  
Milton A. Alpern,  
Chief Financial Officer  
(Principal Financial Officer)

**Table of Contents****EXHIBIT INDEX****Incorporated by Reference****(Unless Otherwise Indicated)****Exhibit**

<b>Number</b>	<b>Exhibit Title</b>	<b>Form</b>	<b>File</b>	<b>Exhibit</b>	<b>Filing Date</b>
2.1	Agreement and Plan of Merger, dated August 29, 2013 by and among Benefitfocus.com, Inc., Benefitfocus, Inc., and Benefitfocus Mergeco, Inc.	S-1/A	333-190610	2.1	September 5, 2013
3.1.3	Restated Certificate of Incorporation of Benefitfocus, Inc.	10-Q		3.1.3	November 12, 2013
3.2	Amended and Restated Bylaws of Benefitfocus, Inc.	S-1/A	333-190610	3.2	September 5, 2013
4.1	Specimen Certificate for Common Stock.	S-1/A	333-190610	4.1	September 5, 2013
4.3	Form of Second Amended and Restated Investors Rights Agreement, dated , 2013, by and among Benefitfocus, Inc. and certain stockholders named therein.	S-1/A	333-190610	4.3	September 16, 2013
10.2	Form of Second Amended and Restated Voting Agreement, dated , 2013, by and among Benefitfocus, Inc., and certain stockholders named therein.	S-1/A	333-190610	10.2	September 5, 2013
10.3	Amended and Restated 2000 Stock Option Plan.#	S-1	333-190610	10.3	August 14, 2013
10.4	2012 Stock Plan, as amended.#	S-1/A	333-190610	10.4	September 5, 2013
10.5	Form of Grant Notice and Stock Option Agreement under the Amended and Restated 2000 Stock Option Plan.#	S-1	333-190610	10.5	August 14, 2013
10.6	Form of Grant Notice and Stock Option Agreement under the 2012 Stock Plan, as amended.#	S-1	333-190610	10.6	August 14, 2013
10.7	Form of Management Incentive Bonus Program.#	S-1	333-190610	10.7	August 14, 2013
10.11	Form of Employment Agreement.#	S-1	333-190610	10.11	August 14, 2013
10.12	Form of Indemnification Agreement.#	S-1	333-190610	10.12	August 14, 2013



31.1	Certification of the President and Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.	Filed herewith
31.2	Certification of the Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.	Filed herewith
32.1	Certification of the President and Chief Executive Officer, and the Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.	Filed herewith
101.INS	XBRL Instance Document.	Furnished herewith
101.SCH	XBRL Taxonomy Extension Schema Document.	Furnished herewith
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document.	Furnished herewith
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document.	Furnished herewith
101.LAB	XBRL Taxonomy Extension Label Linkbase Document.	Furnished herewith
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document.	Furnished herewith

# Management contract or compensatory plan.