
**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION**
Washington, DC 20549

Form 10-Q

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

For the quarterly period ended December 31, 2018

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

For the transition period from to

Commission file number 001-36348

PAYLOCITY HOLDING CORPORATION

(Exact name of registrant as specified in its charter)

Delaware
(State or other jurisdiction of
incorporation or organization)

46-4066644
(IRS Employer
Identification No.)

1400 American Lane
Schaumburg, Illinois
(Address of principal executive offices)

60173
(Zip Code)

(847) 463-3200
(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

Indicate by check mark whether the registrant has submitted electronically every Interactive Data File required to be submitted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit such files). Yes No

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

Large Accelerated Filer

Accelerated Filer

Non-Accelerated Filer

Smaller Reporting Company

Emerging Growth Company

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

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

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

Paylocity Holding Corporation
Form 10-Q
For the Quarterly Period Ended December 31, 2018

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PART I
FINANCIAL INFORMATION

Item 1. Financial Statements

PAYLOCITY HOLDING CORPORATION
Unaudited Consolidated Balance Sheets
(in thousands, except per share data)

| | June 30, 2018 | December 31, 2018 |
|--|---------------------|----------------------|
| Assets | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 137,193 | \$ 84,114 |
| Corporate investments | 732 | 19,934 |
| Accounts receivable, net | 3,453 | 4,267 |
| Deferred contract costs | — | 17,665 |
| Prepaid expenses and other | 11,248 | 12,553 |
| Total current assets before funds held for clients | 152,626 | 138,533 |
| Funds held for clients | 1,225,614 | 1,258,773 |
| Total current assets | 1,378,240 | 1,397,306 |
| Capitalized internal-use software, net | 21,094 | 23,163 |
| Property and equipment, net | 62,029 | 62,662 |
| Intangible assets, net | 13,002 | 11,876 |
| Goodwill | 9,590 | 9,590 |
| Long-term deferred contract costs | — | 64,598 |
| Long-term prepaid expenses and other | 1,504 | 3,266 |
| Deferred income tax assets, net | 22,140 | 7,891 |
| Total assets | \$ 1,507,599 | \$ 1,580,352 |
| Liabilities and Stockholders' Equity | | |
| Current liabilities: | | |
| Accounts payable | \$ 2,990 | \$ 3,498 |
| Accrued expenses | 42,241 | 43,207 |
| Total current liabilities before client fund obligations | 45,231 | 46,705 |
| Client fund obligations | 1,225,614 | 1,258,773 |
| Total current liabilities | 1,270,845 | 1,305,478 |
| Deferred rent | 22,812 | 22,342 |
| Other long-term liabilities | 1,118 | 1,595 |
| Total liabilities | \$ 1,294,775 | \$ 1,329,415 |
| Stockholders' equity: | | |
| Preferred stock, \$0.001 par value, 5,000 authorized, no shares issued and outstanding at June 30, 2018 and December 31, 2018 | \$ — | \$ — |
| Common stock, \$0.001 par value, 155,000 shares authorized at June 30, 2018 and December 31, 2018; 52,758 shares issued and outstanding at June 30, 2018 and 52,887 shares issued and outstanding at December 31, 2018 | 53 | 53 |
| Additional paid-in capital | 219,588 | 189,473 |
| Retained earnings (accumulated deficit) | (6,678) | 61,550 |
| Accumulated other comprehensive loss | (139) | (139) |
| Total stockholders' equity | \$ 212,824 | \$ 250,937 |
| Total liabilities and stockholders' equity | \$ 1,507,599 | \$ 1,580,352 |

See accompanying notes to unaudited consolidated financial statements.

PAYLOCITY HOLDING CORPORATION
Unaudited Consolidated Statements of Operations and Comprehensive Income
(in thousands, except per share data)

| | Three Months Ended December 31, | | Six Months Ended December 31, | |
|--|------------------------------------|-----------------|----------------------------------|------------------|
| | 2017 | 2018 | 2017 | 2018 |
| Revenues: | | | | |
| Recurring fees | \$ 81,292 | \$ 100,275 | \$ 158,586 | \$ 196,036 |
| Interest income on funds held for clients | 1,783 | 4,465 | 3,400 | 7,967 |
| Total recurring revenues | 83,075 | 104,740 | 161,986 | 204,003 |
| Implementation services and other | 2,929 | 2,464 | 5,518 | 3,705 |
| Total revenues | 86,004 | 107,204 | 167,504 | 207,708 |
| Cost of revenues: | | | | |
| Recurring revenues | 25,638 | 31,206 | 49,729 | 60,437 |
| Implementation services and other | 11,202 | 6,864 | 22,070 | 13,575 |
| Total cost of revenues | 36,840 | 38,070 | 71,799 | 74,012 |
| Gross profit | 49,164 | 69,134 | 95,705 | 133,696 |
| Operating expenses: | | | | |
| Sales and marketing | 21,598 | 26,570 | 42,778 | 52,988 |
| Research and development | 9,274 | 12,798 | 18,169 | 24,198 |
| General and administrative | 18,159 | 22,739 | 34,110 | 45,707 |
| Total operating expenses | 49,031 | 62,107 | 95,057 | 122,893 |
| Operating income | 133 | 7,027 | 648 | 10,803 |
| Other income | 141 | 346 | 250 | 615 |
| Income before income taxes | 274 | 7,373 | 898 | 11,418 |
| Income tax expense (benefit) | (157) | 1,669 | (76) | (4,138) |
| Net income | \$ 431 | \$ 5,704 | \$ 974 | \$ 15,556 |
| Other comprehensive loss, net of tax | | | | |
| Unrealized losses on securities, net of tax | (105) | (15) | (110) | — |
| Total other comprehensive loss, net of tax | (105) | (15) | (110) | — |
| Comprehensive income | \$ 326 | \$ 5,689 | \$ 864 | \$ 15,556 |
| Net income per share: | | | | |
| Basic | \$ 0.01 | \$ 0.11 | \$ 0.02 | \$ 0.29 |
| Diluted | \$ 0.01 | \$ 0.10 | \$ 0.02 | \$ 0.28 |
| Weighted-average shares used in computing net income per share: | | | | |
| Basic | 52,502 | 52,842 | 52,197 | 52,853 |
| Diluted | 54,818 | 55,081 | 54,639 | 55,232 |

See accompanying notes to unaudited consolidated financial statements.

PAYLOCITY HOLDING CORPORATION
Unaudited Consolidated Statement of Changes in Stockholders' Equity
(in thousands)

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

See accompanying notes to the unaudited consolidated financial statements.

PAYLOCITY HOLDING CORPORATION
Unaudited Consolidated Statements of Cash Flows
(in thousands)

| | Six Months Ended December 31, | |
|--|----------------------------------|-----------|
| | 2017 | 2018 |
| Cash flows from operating activities: | | |
| Net income | \$ 974 | \$ 15,556 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Stock-based compensation expense | 14,424 | 19,524 |
| Depreciation and amortization expense | 13,438 | 16,801 |
| Deferred income tax benefit | (93) | (4,139) |
| Provision for doubtful accounts | 76 | 112 |
| Net accretion of discounts and amortization of premiums on available-for-sale securities | (141) | (893) |
| Net realized losses on sales of available-for-sale securities | 2 | — |
| Loss on disposal of equipment | 106 | 357 |
| Changes in operating assets and liabilities: | | |
| Accounts receivable | (775) | (926) |
| Deferred contract costs | — | (14,156) |
| Prepaid expenses and other | 1,583 | 635 |
| Accounts payable | (88) | 147 |
| Accrued expenses | (1,290) | 1,027 |
| Tenant improvement allowance | 5,952 | 251 |
| Net cash provided by operating activities | 34,168 | 34,296 |
| Cash flows from investing activities: | | |
| Purchases of available-for-sale securities | (95,207) | (117,054) |
| Proceeds from sales and maturities of available-for-sale securities | 23,181 | 88,879 |
| Net change in funds held for clients' cash and cash equivalents | (331,078) | (24,191) |
| Capitalized internal-use software costs | (7,146) | (9,425) |
| Purchases of property and equipment | (7,998) | (7,532) |
| Lease allowances used for tenant improvements | (5,952) | (251) |
| Net cash used in investing activities | (424,200) | (69,574) |
| Cash flows from financing activities: | | |
| Net change in client fund obligations | 403,243 | 33,159 |
| Repurchases of common shares | — | (34,991) |
| Proceeds from exercise of stock options | — | 85 |
| Proceeds from employee stock purchase plan | 2,045 | 2,824 |
| Taxes paid related to net share settlement of equity awards | (7,697) | (18,878) |
| Net cash provided by (used in) financing activities | 397,591 | (17,801) |
| Net Change in Cash and Cash Equivalents | 7,559 | (53,079) |
| Cash and Cash Equivalents—Beginning of Period | 103,468 | 137,193 |
| Cash and Cash Equivalents—End of Period | \$ 111,027 | \$ 84,114 |
| Supplemental Disclosure of Non-Cash Investing and Financing Activities | | |
| Purchase of property and equipment and internal-use software, accrued but not paid | \$ 482 | \$ 252 |
| Supplemental Disclosure of Cash Flow Information | | |
| Cash paid for income taxes, net of refunds | \$ 60 | \$ 357 |

See accompanying notes to unaudited consolidated financial statements.

PAYLOCITY HOLDING CORPORATION
Notes to the Unaudited Consolidated Financial Statements
(all amounts in thousands, except per share data)

(1) Organization and Description of Business

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

(2) Summary of Significant Accounting Policies

(a) Consolidation and Use of Estimates

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

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

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

(b) Interim Unaudited Consolidated Financial Information

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

(c) Revenue Recognition

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

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

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

- Payroll processing and related services, including payroll reporting and tax filing services are delivered on a weekly, biweekly, semi-monthly, or monthly basis depending upon the payroll frequency of the client and on an annual basis if a client selects W-2 preparation and processing services,
- Time and attendance reporting services, including time clock rentals, are delivered on a monthly basis, and
- Cloud-based HR software solutions, including employee administration and benefits enrollment and administration, are delivered on a monthly basis.

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

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

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

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

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

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

Deferred revenue

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

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

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

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

Deferred contract costs

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

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

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

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

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

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

Remaining Performance Obligations

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

(d) *Income Taxes*

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

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

(e) *Recently Adopted Accounting Standards*

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

(f) Recently Issued Accounting Standards

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

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

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

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

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

(3) Balance Sheet Information

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

Activity in the allowance for doubtful accounts was as follows:

| | |
|------------------------------|---------------|
| Balance at June 30, 2018 | \$ 375 |
| Charged to expense | 112 |
| Write-offs | (103) |
| Balance at December 31, 2018 | <u>\$ 384</u> |

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

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

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

Property and equipment, net consist of the following:

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

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

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

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

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

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

| | |
|--------------------------|------------------|
| Remainder of fiscal 2019 | \$ 1,125 |
| Fiscal 2020 | 2,251 |
| Fiscal 2021 | 2,251 |
| Fiscal 2022 | 2,232 |
| Fiscal 2023 | 2,118 |
| Thereafter | 1,899 |
| Total | <u>\$ 11,876</u> |

The components of accrued expenses were as follows:

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

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

| | |
|------------------------------|-----------------|
| Balance at June 30, 2018 | \$ 3,261 |
| Payments | (1,211) |
| Adjustments | 69 |
| Balance at December 31, 2018 | <u>\$ 2,119</u> |

(4) Corporate Investments and Funds Held for Clients

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

| Type of Issue | June 30, 2018 | | | Fair value |
|---|---------------------|------------------------------|-------------------------------|---------------------|
| | Amortized cost | Gross unrealized gains | Gross unrealized losses | |
| Cash and cash equivalents | \$ 137,193 | \$ — | \$ — | \$ 137,193 |
| Funds held for clients' cash and cash equivalents | 1,102,541 | — | (3) | 1,102,538 |
| Available-for-sale securities: | | | | |
| Commercial paper | 50,703 | 3 | (4) | 50,702 |
| Corporate bonds | 37,508 | 8 | (134) | 37,382 |
| Asset-backed securities | 25,901 | 1 | (55) | 25,847 |
| U.S. treasury securities | 9,879 | — | (2) | 9,877 |
| Total available-for-sale securities (1) | <u>123,991</u> | <u>12</u> | <u>(195)</u> | <u>123,808</u> |
| Total investments | <u>\$ 1,363,725</u> | <u>\$ 12</u> | <u>\$ (198)</u> | <u>\$ 1,363,539</u> |

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

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

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

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

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

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

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

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

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

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

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

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

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

(5) Fair Value Measurement

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

- Level 1—Quoted prices in active markets for identical assets and liabilities.
- Level 2—Quoted prices in active markets for similar assets and liabilities, or other inputs that are observable for the asset or liability, either directly or indirectly, for substantially the full term of the financial instrument.
- Level 3—Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets and liabilities. This includes certain pricing models, discounted cash flow methodologies and similar techniques that use significant unobservable inputs.

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

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

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

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

| | December 31, 2018 | | | |
|---|---------------------|---------------------|-------------------|-------------|
| | Total | Level 1 | Level 2 | Level 3 |
| Cash and cash equivalents | \$ 84,114 | \$ 79,327 | \$ 4,787 | \$ — |
| Funds held for clients' cash and cash equivalents | 1,126,730 | 1,108,906 | 17,824 | — |
| Available-for-sale securities: | | | | |
| Commercial paper | 60,731 | — | 60,731 | — |
| Corporate bonds | 36,499 | — | 36,499 | — |
| Asset-backed securities | 39,487 | — | 39,487 | — |
| U.S. treasury securities | 16,155 | — | 16,155 | — |
| Total available-for-sale securities | 152,872 | — | 152,872 | — |
| Total investments | <u>\$ 1,363,716</u> | <u>\$ 1,188,233</u> | <u>\$ 175,483</u> | <u>\$ —</u> |

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

(6) Benefit Plans

(a) Equity Incentive Plan

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

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

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

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

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

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

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

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

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

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

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

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

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

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

| | Units | Weighted average grant date fair value |
|--|-------|--|
| RSU balance at July 1, 2018 | 1,879 | \$ 43.39 |
| RSUs granted | 736 | \$ 66.26 |
| RSUs vested | (604) | \$ 41.01 |
| RSUs forfeited | (113) | \$ 46.17 |
| RSU balance at December 31, 2018 | 1,898 | \$ 52.86 |
| RSUs expected to vest at December 31, 2018 | 1,720 | \$ 52.68 |

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

(b) Employee Stock Purchase Plan

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

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

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

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

(c) 401(k) Plan

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

(7) Net Income Per Share

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

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

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

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

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

(8) Income Taxes

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

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

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

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

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

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

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

Overview

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

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

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

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

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

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

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

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

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

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

Key Metrics

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

Recurring Revenue Growth

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

Adjusted Gross Profit, Adjusted Recurring Gross Profit and Adjusted EBITDA

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

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

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

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

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

| | Three Months Ended December 31, | | Six Months Ended December 31, | |
|--|------------------------------------|-----------|----------------------------------|-----------|
| | 2017 | 2018 | 2017 | 2018 |
| | (in thousands) | | (in thousands) | |
| Reconciliation from Total Recurring Revenues to Adjusted Recurring Gross Profit | | | | |
| Total recurring revenues | \$83,075 | \$104,740 | \$161,986 | \$204,003 |
| Cost of recurring revenues | 25,638 | 31,206 | 49,729 | 60,437 |
| Recurring gross profit | 57,437 | 73,534 | 112,257 | 143,566 |
| Amortization of capitalized internal-use software costs | 3,314 | 4,418 | 6,703 | 8,630 |
| Stock-based compensation expense and employer payroll taxes related to stock releases and option exercises | 753 | 885 | 1,490 | 1,969 |
| Adjusted Recurring Gross Profit | \$61,504 | \$78,837 | \$120,450 | \$154,165 |

| | Three Months Ended December 31, | | Six Months Ended December 31, | |
|--|------------------------------------|----------|----------------------------------|----------|
| | 2017 | 2018 | 2017 | 2018 |
| | (in thousands) | | (in thousands) | |
| Reconciliation from Net Income to Adjusted EBITDA | | | | |
| Net Income | \$431 | \$5,704 | \$974 | \$15,556 |
| Income tax expense (benefit) | (157) | 1,669 | (76) | (4,138) |
| Depreciation and amortization expense | 6,765 | 8,569 | 13,438 | 16,801 |
| EBITDA | 7,039 | 15,942 | 14,336 | 28,219 |
| Stock-based compensation expense and employer payroll taxes related to stock releases and option exercises | 8,206 | 10,158 | 15,501 | 21,144 |
| Adjusted EBITDA | \$15,245 | \$26,100 | \$29,837 | \$49,363 |

Basis of Presentation

Revenues

Recurring Fees

We derive the majority of our revenues from recurring fees attributable to our cloud-based payroll and HCM software solutions. Recurring fees for each client generally include a base fee in addition to a fee based on the number of client employees and the number of products a client uses. We also charge fees attributable to our preparation of W-2 documents and annual required filings on behalf of our clients. Over the past three years, our client size has been on average over 100 employees. We derive revenue from a client based on the solutions purchased by the client, the number of client employees as well as the amount, type and timing of services provided with respect to those client employees.

As such, the number of client employees on our system is not a good indicator of our financial results in any period. Recurring fees attributable to our cloud-based payroll and HCM solutions accounted for 95% of our total revenues during both the three and six months ended December 31, 2017 and 94% of our total revenues during both the three and six months ended December 31, 2018.

While the majority of our agreements with clients are generally cancellable by the client on 60 days' notice or less, we began entering into term arrangements in fiscal 2018, which are generally two years long. Our agreements do not include general rights of return and do not provide clients with the right to take possession of the software supporting the services being provided. We recognize recurring fees in the period in which services are provided and the related performance obligations have been satisfied.

Interest Income on Funds Held for Clients

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

Implementation Services and Other

Implementation services and other revenues primarily consist of implementation fees charged to new clients for professional services provided to implement our payroll and HCM solutions. Implementations of our payroll solutions typically require only three to four weeks at which point the new client's payroll is first processed using our solution. We implement additional HCM products as requested by clients and leverage the data within our payroll solution to accelerate our implementation processes. With the adoption of Topic 606, we defer implementation fees related to our proprietary products over a period generally up to 24 months, which previously were recognized upon completion. Refer to Note 2 of the Notes to the Unaudited Consolidated Financial Statements for additional information regarding the adoption of Topic 606.

Cost of Revenues

Cost of Recurring Revenues

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

We capitalize a portion of our internal-use software costs, which are then all amortized as a cost of recurring revenues. We amortized \$3.3 million and \$4.4 million of capitalized internal-use software costs during the three months ended December 31, 2017 and 2018, respectively, and \$6.7 million and \$8.6 million of capitalized internal-use software costs during the six months ended December 31, 2017 and 2018, respectively.

Cost of Implementation Services and Other

Cost of implementation services and other consists primarily of employee-related expenses, including wages, stock-based compensation, bonuses and benefits involved in the implementation of our payroll and other HCM solutions for new clients. With the adoption of Topic 606, cost of implementation services related to our proprietary products are capitalized and amortized over a period of 7 years, which previously were expensed as incurred. We intend to grow our business through acquisition of new clients, and doing so will require increased personnel to implement our solutions. Therefore, our cost of implementation services and other is expected to increase in absolute dollars for the foreseeable future. Refer to Note 2 of the Notes to the Unaudited Consolidated Financial Statements for additional information regarding the adoption of Topic 606.

Operating Expenses

Sales and Marketing

Sales and marketing expenses consist primarily of employee-related expenses for our direct sales and marketing staff, including wages, commissions, stock-based compensation, bonuses and benefits, marketing expenses and other related costs. With the adoption of Topic 606, we capitalize certain selling and commission costs related to new contracts or purchases of additional services by our existing clients, which were previously expensed as incurred. Commissions are typically paid within two months after the start of service. Bonuses paid to sales staff for attainment of certain annual performance criteria are accrued in the fiscal year in which they are earned and are subsequently paid annually in the first fiscal quarter of the following year. We generally recognize these costs over a period of 7 years. Refer to Note 2 of the Notes to the Unaudited Consolidated Financial Statements for additional information regarding the adoption of Topic 606.

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

Research and Development

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

We capitalize a portion of our development costs related to internal-use software. The timing of our capitalized development projects may affect the amount of development costs expensed in any given period. The table below sets forth the amounts of capitalized and expensed research and development expenses for the three and six months ended December 31, 2017 and 2018.

| | Three Months Ended December 31, | | Six Months Ended December 31, | |
|---|------------------------------------|-----------|----------------------------------|-----------|
| | 2017 | 2018 | 2017 | 2018 |
| | (in thousands) | | (in thousands) | |
| Capitalized portion of research and development | \$ 4,121 | \$ 5,547 | \$ 8,095 | \$ 10,699 |
| Expensed portion of research and development | 9,274 | 12,798 | 18,169 | 24,198 |
| Total research and development | \$ 13,395 | \$ 18,345 | \$ 26,264 | \$ 34,897 |

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

General and Administrative

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

Other Income

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

Results of Operations

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

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

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

| | Three Months Ended December 31, | | Six Months Ended December 31, | |
|--|------------------------------------|-------|----------------------------------|-------|
| | 2017 | 2018 | 2017 | 2018 |
| Consolidated Statements of Operations Data: | | | | |
| Revenues: | | | | |
| Recurring fees | 95 % | 94 % | 95 % | 94 % |
| Interest income on funds held for clients | 2 % | 4 % | 2 % | 4 % |
| Total recurring revenues | 97 % | 98 % | 97 % | 98 % |
| Implementation services and other | 3 % | 2 % | 3 % | 2 % |
| Total revenues | 100 % | 100 % | 100 % | 100 % |
| Cost of revenues: | | | | |
| Recurring revenues | 30 % | 29 % | 30 % | 29 % |
| Implementation services and other | 13 % | 6 % | 13 % | 7 % |
| Total cost of revenues | 43 % | 35 % | 43 % | 36 % |
| Gross profit | 57 % | 65 % | 57 % | 64 % |
| Operating expenses: | | | | |
| Sales and marketing | 25 % | 25 % | 25 % | 25 % |
| Research and development | 11 % | 12 % | 11 % | 12 % |
| General and administrative | 20 % | 21 % | 20 % | 22 % |
| Total operating expenses | 56 % | 58 % | 56 % | 59 % |
| Operating income | 1 % | 7 % | 1 % | 5 % |
| Other income | 0 % | 0 % | 0 % | 0 % |
| Income before income taxes | 1 % | 7 % | 1 % | 5 % |
| Income tax expense (benefit) | 0 % | 2 % | 0 % | (2)% |
| Net income | 1 % | 5 % | 1 % | 7 % |

Comparison of Three Months Ended December 31, 2017 and 2018

Revenues

(\$ in thousands)

| | Three Months Ended December 31, | | Change | |
|---|------------------------------------|------------|-----------|-------|
| | 2017 | 2018 | \$ | % |
| Recurring fees | \$ 81,292 | \$ 100,275 | \$ 18,983 | 23 % |
| Percentage of total revenues | 95 % | 94 % | | |
| Interest income on funds held for clients | \$ 1,783 | \$ 4,465 | \$ 2,682 | 150 % |
| Percentage of total revenues | 2 % | 4 % | | |
| Implementation services and other | \$ 2,929 | \$ 2,464 | \$ (465) | (16)% |
| Percentage of total revenues | 3 % | 2 % | | |

Recurring Fees

Recurring fees for the three months ended December 31, 2018 increased by \$19.0 million, or 23%, to \$100.3 million from \$81.3 million for the three months ended December 31, 2017. Recurring fees increased primarily as a result of incremental revenues from new and existing clients.

Interest Income on Funds Held for Clients

Interest income on funds held for clients for the three months ended December 31, 2018 increased by \$2.7 million, or 150% to \$4.5 million from \$1.8 million for the three months ended December 31, 2017. Interest income on funds held for clients increased primarily as a result of higher average interest rates, increased average daily balances for

funds held due to the addition of new clients to our client base and interest income from investing a larger portion of our funds held for clients in marketable securities.

Implementation Services and Other

Implementation services and other revenue for the three months ended December 31, 2018 decreased by \$0.5 million, or 16%, to \$2.5 million from \$2.9 million for the three months ended December 31, 2017. Implementation services and other revenue decreased primarily due to the change in the treatment of implementation fees related to our proprietary products. Historically, we have recognized implementation fees upon completion. Starting July 1, 2018, we concluded that implementation fees related to our proprietary products are not separate performance obligations, and as a result, the related implementation fees are deferred and amortized generally over a period up to 24 months. Refer to Note 2 of the Notes to the Unaudited Consolidated Financial Statements for additional information.

Cost of Revenues

(\$ in thousands)

| | Three Months Ended December 31, | | Change | |
|---|--|-------------|---------------|----------|
| | 2017 | 2018 | \$ | % |
| Cost of recurring revenues | \$ 25,638 | \$ 31,206 | \$ 5,568 | 22 % |
| Percentage of recurring revenues | 31 % | 30 % | | |
| Recurring gross margin | 69 % | 70 % | | |
| Cost of implementation services and other | \$ 11,202 | \$ 6,864 | \$ (4,338) | (39)% |
| Percentage of implementation services and other | 382 % | 279 % | | |
| Implementation gross margin | (282)% | (179)% | | |

Cost of Recurring Revenues

Cost of recurring revenues for the three months ended December 31, 2018 increased by \$5.6 million, or 22%, to \$31.2 million from \$25.6 million for the three months ended December 31, 2017. Cost of recurring revenues increased primarily as a result of the continued growth of our business, in particular, \$3.0 million in additional employee-related costs resulting from additional personnel necessary to provide services to new and existing clients, \$1.3 million in delivery and other processing-related fees and \$1.1 million in increased internal-use software amortization. Recurring gross margin was 69% and 70% for the three months ended December 31, 2017 and 2018, respectively.

Cost of Implementation Services and Other

Cost of implementation services and other for the three months ended December 31, 2018 decreased by \$4.3 million, or 39%, to \$6.9 million from \$11.2 million for the three months ended December 31, 2017. The decrease in cost of implementation services and other was primarily due to the deferral of certain implementation costs over a period of 7 years related to our proprietary products upon the adoption of Topic 606 on July 1, 2018, partially offset by additional employee-related costs resulting from additional personnel. Refer to Note 2 of the Notes to the Unaudited Consolidated Financial Statements for additional information regarding the adoption of Topic 606.

Operating Expenses

(\$ in thousands)

Sales and Marketing

| | Three Months Ended December 31, | | Change | |
|------------------------------|--|-------------|---------------|----------|
| | 2017 | 2018 | \$ | % |
| Sales and marketing | \$ 21,598 | \$ 26,570 | \$ 4,972 | 23 % |
| Percentage of total revenues | 25 % | 25 % | | |

Sales and marketing expenses for the three months ended December 31, 2018 increased by \$5.0 million, or 23%, to \$26.6 million from \$21.6 million for the three months ended December 31, 2017. The increase in sales and

marketing expense was primarily the result of additional employee-related costs from the expansion of our sales team (including management, sales engineers, direct sales, sales administration and sales lead generation support), partially offset by the deferral of certain selling and commissions costs over a period of 7 years related to the adoption of Topic 606 on July 1, 2018. Refer to Note 2 of the Notes to the Unaudited Consolidated Financial Statements for additional information regarding the adoption of Topic 606.

Research and Development

| | Three Months Ended December 31, | | Change | |
|------------------------------|------------------------------------|-----------|----------|------|
| | 2017 | 2018 | \$ | % |
| Research and development | \$ 9,274 | \$ 12,798 | \$ 3,524 | 38 % |
| Percentage of total revenues | 11 % | 12 % | | |

Research and development expenses for the three months ended December 31, 2018 increased by \$3.5 million, or 38%, to \$12.8 million from \$9.3 million for the three months ended December 31, 2017. The increase in research and development expenses was primarily the result of \$4.0 million of additional employee-related costs related to additional development personnel and \$0.7 million in additional stock-based compensation associated with our equity incentive plan, partially offset by higher period-over-period capitalized internal-use software costs of \$1.4 million.

General and Administrative

| | Three Months Ended December 31, | | Change | |
|------------------------------|------------------------------------|-----------|----------|------|
| | 2017 | 2018 | \$ | % |
| General and administrative | \$ 18,159 | \$ 22,739 | \$ 4,580 | 25 % |
| Percentage of total revenues | 20 % | 21 % | | |

General and administrative expenses for the three months ended December 31, 2018 increased by \$4.6 million, or 25%, to \$22.7 million from \$18.2 million for the three months ended December 31, 2017. The increase in general and administrative expense was primarily the result of \$1.8 million of additional employee-related costs and \$1.8 million in additional stock-based compensation associated with our equity incentive plan.

Other Income

| | Three Months Ended December 31, | | Change | |
|------------------------------|------------------------------------|--------|--------|-------|
| | 2017 | 2018 | \$ | % |
| Other income | \$ 141 | \$ 346 | \$ 205 | 145 % |
| Percentage of total revenues | 0 % | 0 % | | |

Other income for the three months ended December 31, 2018 increased by \$0.2 million as compared to the three months ended December 31, 2017. The increase in other income was primarily due to interest income earned on our cash and cash equivalents and corporate investments.

Income Tax Expense (Benefit)

| | Three Months Ended December 31, | | Change | |
|------------------------------|------------------------------------|----------|----------|---|
| | 2017 | 2018 | \$ | % |
| Income tax expense (benefit) | \$ (157) | \$ 1,669 | \$ 1,826 | * |
| Percentage of total revenues | 0 % | 2 % | | |

* Not Meaningful

The difference in income tax expense (benefit) of \$1.8 million for the three months ended December 31, 2018 as compared to the three months ended December 31, 2017 was primarily due to the provision for income taxes through

December 31, 2018 of \$2.3 million, partially offset by a \$0.5 million benefit from excess benefits realized from employee stock exercises.

Comparison of Six Months Ended December 31, 2017 and 2018

Revenues

(\$ in thousands)

| | Six Months Ended December 31, | | Change | |
|---|----------------------------------|------------|------------|-------|
| | 2017 | 2018 | \$ | % |
| Recurring fees | \$ 158,586 | \$ 196,036 | \$ 37,450 | 24 % |
| Percentage of total revenues | 95 % | 94 % | | |
| Interest income on funds held for clients | \$ 3,400 | \$ 7,967 | \$ 4,567 | 134 % |
| Percentage of total revenues | 2 % | 4 % | | |
| Implementation services and other | \$ 5,518 | \$ 3,705 | \$ (1,813) | (33)% |
| Percentage of total revenues | 3 % | 2 % | | |

Recurring Fees

Recurring fees for the six months ended December 31, 2018 increased by \$37.5 million, or 24%, to \$196.0 million from \$158.6 million for the six months ended December 31, 2017. Recurring fees increased primarily as a result of incremental revenues from new and existing clients.

Interest Income on Funds Held for Clients

Interest income on funds held for clients for the six months ended December 31, 2018 increased by \$4.6 million, or 134% to \$8.0 million from \$3.4 million for the six months ended December 31, 2017. Interest income on funds held for clients increased primarily as a result of higher average interest rates, increased average daily balances for funds held due to the addition of new clients to our client base and interest income from investing a larger portion of our funds held for clients in marketable securities.

Implementation Services and Other

Implementation services and other revenue for the six months ended December 31, 2018 decreased by \$1.8 million, or 33%, to \$3.7 million from \$5.5 million for the six months ended December 31, 2017. Implementation services and other revenue decreased primarily due to the change in the treatment of implementation fees related to our proprietary products. Historically, we have recognized implementation fees upon completion. Starting July 1, 2018, we concluded that implementation fees related to our proprietary products are not separate performance obligations, and as a result, the related implementation fees are deferred and amortized generally over a period up to 24 months. Refer to Note 2 of the Notes to the Unaudited Consolidated Financial Statements for additional information.

Cost of Revenues

(\$ in thousands)

| | Six Months Ended December 31, | | Change | |
|---|----------------------------------|-----------|------------|-------|
| | 2017 | 2018 | \$ | % |
| Cost of recurring revenues | \$ 49,729 | \$ 60,437 | \$ 10,708 | 22 % |
| Percentage of recurring revenues | 31 % | 30 % | | |
| Recurring gross margin | 69 % | 70 % | | |
| Cost of implementation services and other | \$ 22,070 | \$ 13,575 | \$ (8,495) | (38)% |
| Percentage of implementation services and other | 400 % | 366 % | | |
| Implementation gross margin | (300)% | (266)% | | |

Cost of Recurring Revenues

Cost of recurring revenues for the six months ended December 31, 2018 increased by \$10.7 million, or 22%, to \$60.4 million from \$49.7 million for the six months ended December 31, 2017. Cost of recurring revenues increased primarily as a result of the continued growth of our business, in particular, \$5.5 million in additional employee-related costs resulting from additional personnel necessary to provide services to new and existing clients, \$2.9 million in delivery and other processing-related fees and \$1.9 million in increased internal-use software amortization. Recurring gross margin was 69% and 70% for the six months ended December 31, 2017 and 2018, respectively.

Cost of Implementation Services and Other

Cost of implementation services and other for the six months ended December 31, 2018 decreased by \$8.5 million, or 38%, to \$13.6 million from \$22.1 million for the six months ended December 31, 2017. The decrease in cost of implementation services and other was primarily due to the deferral of certain implementation costs over a period of 7 years related to our proprietary products upon the adoption of Topic 606 on July 1, 2018, partially offset by additional employee-related costs resulting from additional personnel. Refer to Note 2 of the Notes to the Unaudited Consolidated Financial Statements for additional information regarding the adoption of Topic 606.

Operating Expenses

(\$ in thousands)

Sales and Marketing

| | Six Months Ended December 31, | | Change | |
|------------------------------|----------------------------------|-----------|-----------|------|
| | 2017 | 2018 | \$ | % |
| Sales and marketing | \$ 42,778 | \$ 52,988 | \$ 10,210 | 24 % |
| Percentage of total revenues | 25 % | 25 % | | |

Sales and marketing expenses for the six months ended December 31, 2018 increased by \$10.2 million, or 24%, to \$53.0 million from \$42.8 million for the six months ended December 31, 2017. The increase in sales and marketing expense was primarily the result of additional employee-related costs from the expansion of our sales team (including management, sales engineers, direct sales, sales administration and sales lead generation support), partially offset by the deferral of certain selling and commissions costs over a period of 7 years related to the adoption of Topic 606 on July 1, 2018. Refer to Note 2 of the Notes to the Unaudited Consolidated Financial Statements for additional information regarding the adoption of Topic 606.

Research and Development

| | Six Months Ended December 31, | | Change | |
|------------------------------|----------------------------------|-----------|----------|------|
| | 2017 | 2018 | \$ | % |
| Research and development | \$ 18,169 | \$ 24,198 | \$ 6,029 | 33 % |
| Percentage of total revenues | 11 % | 12 % | | |

Research and development expenses for the six months ended December 31, 2018 increased by \$6.0 million, or 33%, to \$24.2 million from \$18.2 million for the six months ended December 31, 2017. The increase in research and development expenses was primarily the result of \$7.0 million of additional employee-related costs related to additional development personnel and \$1.3 million in additional stock-based compensation associated with our equity incentive plan, partially offset by higher period-over-period capitalized internal-use software costs of \$2.5 million.

General and Administrative

| | Six Months Ended December 31, | | Change | |
|------------------------------|----------------------------------|-----------|-----------|------|
| | 2017 | 2018 | \$ | % |
| General and administrative | \$ 34,110 | \$ 45,707 | \$ 11,597 | 34 % |
| Percentage of total revenues | 20 % | 22 % | | |

General and administrative expenses for the six months ended December 31, 2018 increased by \$11.6 million, or 34%, to \$45.7 million from \$34.1 million for the six months ended December 31, 2017. The increase in general and administrative expense was primarily the result of \$4.9 million of additional employee-related costs and \$4.2 million in additional stock-based compensation associated with our equity incentive plan.

Other Income

| | Six Months Ended December 31, | | Change | |
|------------------------------|----------------------------------|--------|--------|-------|
| | 2017 | 2018 | \$ | % |
| Other income | \$ 250 | \$ 615 | \$ 365 | 146 % |
| Percentage of total revenues | 0 % | 0 % | | |

Other income for the six months ended December 31, 2018 increased by \$0.4 million as compared to the six months ended December 31, 2017. The increase in other income was primarily due to interest income earned on our cash and cash equivalents and corporate investments, partially offset by loss on the disposal of property and equipment.

Income Tax Expense (Benefit)

| | Six Months Ended December 31, | | Change | |
|------------------------------|----------------------------------|------------|------------|---------|
| | 2017 | 2018 | \$ | % |
| Income tax expense (benefit) | \$ (76) | \$ (4,138) | \$ (4,062) | 5,345 % |
| Percentage of total revenues | 0 % | (2)% | | |

The difference in income tax expense (benefit) of \$4.1 million for the six months ended December 31, 2018 as compared to the six months ended December 31, 2017 was primarily due to \$7.4 million benefit from excess benefits realized from employee stock exercises, partially offset by the provision for income taxes through December 31, 2018 of \$3.3 million.

Quarterly Trends and Seasonality

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

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

Critical Accounting Policies and Estimates

Our management's discussion and analysis of our financial condition and results of operations is based on our consolidated financial statements, which have been prepared in accordance with GAAP. The preparation of these consolidated financial statements requires us to make estimates and assumptions that affect the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities at the date of the consolidated financial statements, and the reported amounts of revenue and expenses. In accordance with GAAP, we base our estimates on historical experience and on various other assumptions that we believe are reasonable under the circumstances. Actual results might differ from these estimates under different assumptions or conditions and, to the extent that there are differences between our estimates and actual results, our future financial statement presentation, financial condition, results of operations and cash flows will be affected. We changed our significant accounting policy for revenue recognition related to our adoption of Topic 606 on July 1, 2018. Refer to Note 2 of the Notes to the Unaudited Consolidated Financial

Statements for additional detail around our revenue recognition policy. Our critical accounting policies and use of estimates are disclosed in our audited consolidated financial statements for the year ended June 30, 2018 included in our Annual Report on Form 10-K filed with the SEC on August 10, 2018.

Liquidity and Capital Resources

Our primary liquidity needs are related to the funding of general business requirements, including working capital requirements, research and development, and capital expenditures. The recently completed share repurchase program was funded by our cash flows from operations. As of December 31, 2018, our principal sources of liquidity were \$84.1 million of cash and cash equivalents and \$20.8 million of total corporate investments.

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

Our cash flows from investing and financing activities are influenced by the amount of funds held for clients, which varies significantly from quarter to quarter. The balance of the funds we hold depends on our clients' payroll calendar, and therefore, such balance changes from period to period in accordance with the timing of each payroll cycle. Funds held for clients are primarily placed in demand deposit accounts with various financial institutions. We also invest portions of our excess cash and cash equivalents and funds held for clients in highly liquid, investment-grade marketable securities. Funds held for clients are used for the repayment of client fund obligations.

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

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

| | Six Months Ended December 31, | |
|---|--------------------------------------|--------------------|
| | 2017 | 2018 |
| Net cash provided by operating activities | \$ 34,168 | \$ 34,296 |
| Cash flows from investing activities: | | |
| Purchases of available-for-sale securities | (95,207) | (117,054) |
| Proceeds from sales and maturities of available-for-sale securities | 23,181 | 88,879 |
| Net change in funds held for clients' cash and cash equivalents | (331,078) | (24,191) |
| Capitalized internal-use software costs | (7,146) | (9,425) |
| Purchases of property and equipment | (7,998) | (7,532) |
| Lease allowances used for tenant improvements | (5,952) | (251) |
| Net cash used in investing activities | (424,200) | (69,574) |
| Cash flows from financing activities: | | |
| Net change in client fund obligations | 403,243 | 33,159 |
| Repurchases of common shares | — | (34,991) |
| Proceeds from exercise of stock options | — | 85 |
| Proceeds from employee stock purchase plan | 2,045 | 2,824 |
| Taxes paid related to net share settlement of equity awards | (7,697) | (18,878) |
| Net cash provided by (used in) financing activities | 397,591 | (17,801) |
| Net change in cash and cash equivalents | <u>\$ 7,559</u> | <u>\$ (53,079)</u> |

Operating Activities

Net cash provided by operating activities was \$34.2 million and \$34.3 million for the six months ended December 31, 2017 and 2018, respectively. The increase in net cash provided by operating activities from the six months ended December 31, 2017 to the six months ended December 31, 2018 was primarily due to improved operating results after adjusting for non-cash items including stock-based compensation expense, depreciation and amortization expense and deferred income tax benefit, partially offset by changes in operating assets and liabilities, mostly driven by changes in deferred contract costs and tenant improvement allowances during the six months ended December 31, 2018.

Investing Activities

Net cash used in investing activities was \$424.2 million and \$69.6 million for the six months ended December 31, 2017 and 2018, respectively.

Changes in net cash used in investing activities are significantly influenced by the amount of funds held for clients at the end of a reporting period. Changes in the amount of funds held for clients from period to period will vary substantially as a result of the timing of payroll and tax obligations due. Our payroll processing activities involve the movement of significant funds from accounts of employers to employees and relevant taxing authorities. During fiscal 2018, we processed over \$110 billion in payroll transactions. Though we debit a client's account prior to any disbursement on its behalf, there is a delay between our payment of amounts due to employees and taxing and other regulatory authorities and when the incoming funds from the client to cover these amounts payable actually clear into our operating accounts. We currently have agreements with eleven banks to execute ACH and wire transfers to support our client payroll and tax services. We believe we have sufficient capacity under these ACH arrangements to handle our transactions for the foreseeable future. Fluctuations in the net change in funds held for clients' cash and cash equivalents are also impacted by the timing of purchases and sales and maturities of investments as we invest a portion of the funds held for clients in highly liquid, investment-grade marketable securities. Beginning in July 2018, we also began investing portions of our excess cash in marketable securities.

Excluding the net change in funds held for clients' cash and cash equivalents and purchases and proceeds from sales and maturities of available-for-sale securities, our net cash used in investing activities was \$21.1 million and \$17.2 million for the six months ended December 31, 2017 and 2018, respectively. The change in net cash used in investing activities was primarily due to a decrease in lease allowances used for tenant improvements of \$5.7 million, partially offset by increased capitalized internal-use software costs of \$2.3 million during the six months ended December 31, 2018 as compared to December 31, 2017.

Financing Activities

Net cash provided by (used in) financing activities was \$397.6 million and \$(17.8) million for the six months ended December 31, 2017 and 2018, respectively. Excluding the net change in client fund obligations, net cash used in financing activities was \$5.7 million and \$51.0 million for the six months ended December 31, 2017 and 2018, respectively. The change in net cash provided by (used in) financing activities, excluding the net change in client fund obligations, was primarily the result of \$35.0 million in repurchases of common shares and an \$11.2 million increase in taxes paid related to net share settlement of equity awards during the six months ended December 31, 2018.

Contractual Obligations and Commitments

Our principal commitments consist of operating lease obligations. The following table summarizes our contractual obligations at December 31, 2018:

| | Total | Payment Due By Fiscal Period | | | More than 5 Years |
|------------------------------------|------------------|------------------------------|-----------------|-----------------|-------------------|
| | | Less than 1 Year | 1-3 Years | 3-5 Years | |
| Operating lease obligations | \$109,820 | \$ 9,318 | \$19,753 | \$17,083 | \$63,666 |
| Unconditional purchase obligations | 4,108 | 3,394 | 714 | — | — |
| | <u>\$113,928</u> | <u>\$12,712</u> | <u>\$20,467</u> | <u>\$17,083</u> | <u>\$63,666</u> |

Capital Expenditures

We expect to continue to invest in capital spending as we continue to grow our business and expand and enhance our operating facilities, data centers and technical infrastructure. Future capital requirements will depend on many factors, including our rate of sales growth. In the event that our sales growth or other factors do not meet our expectations, we may eliminate or curtail capital projects in order to mitigate the impact on our use of cash. Capital expenditures were \$8.0 million and \$7.5 million for the six months ended December 31, 2017 and 2018, respectively, exclusive of capitalized internal-use software costs of \$7.1 million and \$9.4 million for the same periods, respectively.

Off-Balance Sheet Arrangements

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

New Accounting Pronouncements

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

Item 3. Quantitative and Qualitative Disclosures about Market Risk

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

Interest Rate Risk

As of December 31, 2018, we had cash and cash equivalents of \$84.1 million, corporate investments of \$20.8 million and funds held for clients of \$1,258.8 million. We deposit our cash and cash equivalents and significant portions of our funds held for clients in demand deposit accounts with various financial institutions. We invest portions of our excess cash and cash equivalents and funds held for clients in marketable securities including commercial paper, corporate bonds, asset-backed securities and U.S. treasury securities, which were classified as available-for-sale securities as of December 31, 2018. Our investment policy is focused on generating higher yields from these investments while preserving liquidity and capital. However, as a result of our investing activities, we are exposed to changes in interest rates that may materially affect our financial statements.

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

Based upon a sensitivity model that measures market value changes caused by interest rate fluctuations, an immediate 25-basis point increase in interest rates would have resulted in a decrease in the market value of our available-for-sale securities included in funds held for clients by \$0.1 million as of December 31, 2018. A 25-basis point decrease in interest rates would have resulted in a \$0.1 million increase in the market value of our available-for-sale securities included in funds held for clients as of December 31, 2018. Fluctuations in the value of our available-for-sale securities caused by changes in interest rates are recorded in other comprehensive income and are only realized if we sell the underlying securities.

Inflation Risk

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

Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

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

Our management, with the participation of our Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of our disclosure controls and procedures as of December 31, 2018, the end of the period covered by this Quarterly Report on Form 10-Q. Based upon such evaluation, our Chief Executive Officer and Chief Financial Officer have concluded that our disclosure controls and procedures were effective as of such date.

Changes in Internal Control over Financial Reporting

There were no changes in our internal control over financial reporting during the three-month period covered by this Quarterly Report on Form 10-Q that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting. Effective July 1, 2018, we adopted Accounting Standard Codification Topic 606, Revenue from Contracts with Customers (“ASC 606”). Changes were made to the relevant business processes and the related control activities in order to monitor and maintain appropriate controls over financial reporting.

PART II OTHER INFORMATION

Item 1. Legal Proceedings

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

Item 1A. Risk Factors.

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

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

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

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

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

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

- Our ability to hire and retain qualified personnel;
- A repeal of or changes to the laws and regulations related to the products and services which we offer;
- Changes in accounting principles; and
- Unforeseen legal expenses, including litigation and settlement costs.

The majority of our agreements with clients do not have a specified term and are generally cancellable by our clients upon 60 days' or less notice; however, in fiscal 2018, the Company also began entering into term agreements, which are generally two years in length. If a significant number of clients elected to terminate their agreements with us, our operating results and our business would be adversely affected.

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

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

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

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

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

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

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

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

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

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

Our success depends in substantial part on our continuing ability to provide products and services that medium-sized organizations will find superior to our competitors' offerings and will continue to use. We intend to continue to invest significant resources in research and development in order to enhance our existing products and services and introduce new high-quality products that clients will want. If we are unable to predict user preferences or industry changes, or if we are unable to modify our products and services on a timely basis or to effectively bring new products to market, our sales may suffer.

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

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

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

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

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

We have experienced significant growth in the number of users, transactions and data that our operations infrastructure supports. We seek to maintain sufficient excess capacity in our data centers and other operations infrastructure to meet the needs of all of our clients. We also seek to maintain excess capacity to facilitate the rapid

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

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

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

We also rely on computer hardware purchased or leased and software licensed from third parties in order to offer our services. These licenses and hardware are generally commercially available on varying terms. However, it is possible that this hardware and software might not continue to be available on commercially reasonable terms, or at all. Any loss of the right to use any of this hardware or software could result in delays in the provisioning of our services until equivalent technology is either developed by us, or, if available, is identified, obtained and integrated.

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

We host our solutions at a third-party facility in Franklin Park, Illinois and utilize another third-party facility in Kenosha, Wisconsin for backup and disaster recovery. We also may decide to employ additional offsite data centers in the future to accommodate growth. Problems faced by our data center locations, with the telecommunications network providers with whom we or they contract, or with the systems by which our telecommunications providers allocate capacity among their clients, including us, could adversely affect the availability and processing of our solutions and related services and the experience of our clients. If our data centers are unable to keep up with our growing needs for capacity, this could have an adverse effect on our business and cause us to incur additional expense. In addition, any financial difficulties faced by our third-party data center's operator or any of the service providers with whom we or they contract may have negative effects on our business, the nature and extent of which are difficult to predict. Any changes in service levels at our third-party data center or any errors, defects, disruptions or other performance problems with our applications could adversely affect our reputation and may damage our clients' stored files or result in lengthy interruptions in our services. Interruptions in our services might reduce our revenues, subject us to potential liability or other expenses or adversely affect our renewal rates.

In addition, while we own, control and have access to our servers and all of the components of our network that are located in our backup data centers, we do not control the operation of these facilities. The operators of our third party data center facilities have no 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 the data center operators are acquired, we may be required to transfer our servers and other infrastructure to new data center facilities, and we may incur costs and experience service interruption in doing so.

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

Our solutions involve the storage and transmission of our clients' and their employees' proprietary and confidential information. This information includes bank account numbers, tax return information, social security numbers, benefit information, retirement account information, payroll information, system passwords, and in the case of our benefit administration solution, BeneFLEX, health information protected by the Health Insurance Portability and Accountability Act of 1996, as amended, or HIPAA. In addition, we collect and maintain personal information on our own employees in the ordinary course of our business. Finally, our business involves the storage and transmission of funds from the accounts of our clients to their employees, taxing and regulatory authorities and others. As a result, unauthorized access or security breaches of our systems or the systems of our clients could result in the unauthorized disclosure of confidential information, theft, litigation, indemnity obligations and other significant liabilities. Because the techniques used to obtain unauthorized access or sabotage systems change frequently and generally are not identified until they are employed, we may be unable to anticipate these techniques or to implement adequate preventative measures in advance. As cyber threats continue to evolve, we are focused on ensuring that our operating environments safeguard and protect personal and business information. We may be required to invest significant additional resources to comply with evolving cybersecurity regulations and to modify and enhance our information security and controls, and to investigate and remediate any security vulnerabilities. While we have security measures and controls in place to protect confidential information, prevent data loss, theft and other security breaches, including penetration tests of our systems by independent third parties, if our security measures are breached, our business could be substantially harmed and we could incur significant liabilities. The costs of investigating, mitigating, and reporting such a breach to affected individuals (if required) can be substantial. In addition, if a high-profile security breach occurs with respect to an industry peer, our clients and potential clients may generally lose trust in the security of payroll and HCM applications. Any such breach or unauthorized access could negatively affect our ability to attract new clients, cause existing clients to terminate their agreements with us, result in reputational damage and subject us to lawsuits, regulatory fines (including, in the case of our benefit administration solution, BeneFLEX, penalties for failure to comply with HIPAA) or other actions or liabilities which could materially and adversely affect our business and operating results.

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

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

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

We recognize our expenses over varying periods based on the nature of the expense. When a client terminates its relationship with us, we may not have derived enough revenue from that client to cover associated implementation

costs. Our expenses fluctuate as a percentage of revenue, and changes in our business generally may not be immediately reflected in our results of operations.

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

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

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

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

Referrals from third-party service providers, including 401(k) advisors, benefits administrators, insurance brokers, third-party administrators and HR consultants, represent a significant source of potential clients for our products and implementation services. For example, we estimate that more than 25% of our new sales in fiscal 2018 were referred to us from our referral network participants. In most cases, our relationships with referral network participants are informal, although in some cases, we have formalized relationships where we are a recommended vendor for their clients.

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

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

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

We believe that the market for cloud-based payroll and HCM solutions is not as mature among medium-sized organizations as the market for outsourced services or on-premise software and services. It is not certain that cloud-based solutions will achieve and sustain high levels of client demand and market acceptance. Our success will depend to a substantial extent on the widespread adoption by medium-sized organizations of cloud-based computing in general, and of payroll and other HCM applications in particular. It is difficult to predict client adoption rates and demand for our solutions, the future growth rate and size of the cloud-based market or the entry of competitive solutions. The expansion of the cloud-based market depends on a number of factors, including the cost, performance, and perceived value associated with cloud-based computing, as well as the ability of cloud-based solutions to address security and privacy concerns. If other cloud-based providers experience security incidents, loss of client data, disruptions in delivery or other problems, the market for cloud-based applications as a whole, including our solutions, may be negatively affected. If cloud-based payroll and HCM solutions do not achieve widespread adoption among medium-sized organizations, or

there is a reduction in demand for cloud-based computing caused by a lack of client acceptance, technological challenges, weakening economic conditions, security or privacy concerns, competing technologies and products, decreases in corporate spending or otherwise, it could result in a loss of clients, decreased revenues and an adverse impact on our business.

We may not be able to sustain or increase profitability in the future.

We generated net income in fiscal 2017, fiscal 2018 and the first six months of fiscal 2019; however, we may not be able to sustain or increase profitability in future periods. We have been growing our number of clients rapidly, and as we do so, we incur significant sales and marketing, services and other related expenses. Our profitability will be significantly influenced by our ability to attain sufficient scale and productivity to achieve recurring revenues that are sufficient to support the incremental costs to obtain, implement and support new clients. We intend for the foreseeable future to continue to focus predominately on adding new clients, and we also expect to make other significant expenditures and investments in research and development to expand and improve our product offerings and technical infrastructure. We also may not be able to sustain or increase profitability in the future for a number of other unforeseen reasons. Therefore, our profitability may decrease, we may cease to be profitable, or we may incur operating losses in the future.

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

Our payroll processing business involves the movement of significant funds from the account of a client to employees and relevant taxing authorities. For example, in fiscal 2018 we processed over \$110 billion in payroll transactions. Though we debit a client's account prior to any disbursement on its behalf, due to Automated Clearing House, or ACH, banking regulations, funds previously credited could be reversed under certain circumstances and timeframes after our payment of amounts due to employees and taxing and other regulatory authorities. There is therefore a risk that the employer's funds will be insufficient to cover the amounts we have already paid on its behalf. While such shortage and accompanying financial exposure has only occurred in very limited instances in the past, should clients default on their payment obligations in the future, we might be required to advance substantial amounts of funds to cover such obligations. In such an event, we may be required to seek additional sources of short-term liquidity, which may not be available on reasonable terms, if at all, and our operating results and our liquidity could be adversely affected and our banking relationships could be harmed.

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

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

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

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

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

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

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

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

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

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

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

Our clients collect, use and store personal or identifying information regarding their employees and their family members in our solutions. Federal and state government bodies and agencies have adopted, are considering adopting, or may adopt laws and regulations regarding the collection, use, storage and disclosure of such personal information. In addition, HIPAA, as amended by the Health Information Technology for Economic and Clinical Health Act, and its implementing regulations, applies to our benefit administration solution, BeneFLEX, as a business associate. The costs

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

Additionally, we expect that existing laws, regulations, and standards may be interpreted in new and differing manners in the future, and may be inconsistent among jurisdictions. Future laws, regulations, standards, and other obligations, and changes in the interpretation of existing laws, regulations, standards, and other obligations could result in increased regulation, increased costs of compliance and penalties for non-compliance, and limitations on data collection, use, disclosure, and transfer for Paylocity and our clients. For example, in 2016, the European Union ("EU") and United States agreed to a framework for data transferred from the EU to the United States, called the Privacy Shield, but this new framework has been challenged by private parties and may face additional challenges by national regulators or additional private parties. Additionally, in 2016 the EU adopted a new regulation governing data privacy called the General Data Protection Regulation ("GDPR"), which became effective in May 2018. The GDPR establishes new requirements applicable to the handling of personal data and imposes penalties for non-compliance of up to 4% of worldwide revenue. California also recently enacted legislation, the California Consumer Privacy Act of 2018, that will afford consumers expanded privacy protections when it goes into effect on January 1, 2020. Legislators have stated that they intend to propose amendments to this legislation, and it remains unclear what, if any, modifications will be made to this legislation or how it will be interpreted. All of these legislative and regulatory initiatives may adversely affect our clients' ability to process, handle, store, use and transmit demographic and personal information regarding their employees and family members, which could reduce demand for our solutions.

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

If third parties we work with violate applicable laws or regulations or our policies, such violations may also put our clients' content at risk and could in turn have an adverse effect on our business. Any significant change to applicable laws, regulations, or industry practices regarding the collection, use, retention, security, or disclosure of our clients' content, or regarding the manner in which the express or implied consent of clients for the collection, use, retention, or disclosure of such content is obtained, could increase our costs and require us to modify our services and features, possibly in a material manner, which we may be unable to complete, and may limit our ability to store and transmit client data or develop new services and features.

Our business could be adversely affected if we do not effectively implement and service our solutions or if we are unable to accommodate increased demand for our implementation and client services resulting from growth in our business.

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

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

services, or a market perception that we do not maintain high-quality client services, could adversely affect our reputation, our ability to sell our solutions to existing and prospective clients, and our business, operating results and financial position.

In addition, we may be unable to respond quickly enough to accommodate increased client demand for implementation and client services driven by our growth. In order to ensure that we have sufficient employees to implement and service our solutions, we must closely coordinate hiring of personnel with our projected sales for a particular period. Because our sales cycle is typically only three to six weeks long, we may not be successful in coordinating hiring of implementation and client service personnel to meet increased demand for our services. Increased demand for services without a corresponding staffing increase of qualified personnel could adversely affect the quality of services provided to our clients, and our business and our reputation could be harmed.

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

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

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

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

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

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

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

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

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

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

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

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

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

For example, we might lose sales or incur significant expenses if states successfully impose broader guidelines on state sales and use taxes. A successful assertion by one or more states requiring us to collect sales or other taxes on our software or provision of our services could result in substantial tax liabilities for past transactions and otherwise harm our business. Each state has different rules and regulations governing sales and use taxes, and these rules and regulations are subject to varying interpretations that change over time. We review these rules and regulations periodically and, when we believe we are subject to sales and use taxes in a particular state, we may voluntarily engage state tax authorities in order to determine how to comply with that state's rules and regulations. We cannot assure you that we will not be subject to sales and use taxes or related penalties for past sales in states where we currently believe no such taxes are required.

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

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, employment claims made by our current or former employees, or lawsuits related to breaches of personal information. Litigation might result in substantial costs and may divert management's attention and resources, which might seriously harm our business, overall financial condition, and operating results. Insurance might not cover such claims, might not provide sufficient payments to cover all the costs to resolve one or more such claims and might not continue to be available on terms acceptable to us. A claim brought against us that is uninsured or underinsured could result in unanticipated costs, thereby harming our operating results and leading analysts or potential investors to lower their expectations of our performance, which could reduce the trading price of our stock.

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

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

We enter into confidentiality and invention assignment agreements with our employees and consultants and enter into confidentiality agreements with the parties with whom we have strategic relationships and business alliances. No assurance can be given that these agreements will be effective in controlling access to and distribution of our products and proprietary information. The confidentiality agreements on which we rely to protect certain technologies may be breached and may not be adequate to protect our proprietary technologies. Further, these agreements do not prevent our competitors from independently developing technologies that are substantially equivalent or superior to our solutions. In addition, we depend, in part, on technology of third parties licensed to us for our solutions, and the loss or inability to maintain these licenses or errors in the software we license could result in increased costs, reduced service levels or delayed sales of our solutions.

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

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

There is considerable patent and other intellectual property development activity in our industry. Our success depends, in part, upon our not infringing upon the intellectual property rights of others. Our competitors, as well as a number of other entities and individuals, may own or claim to own intellectual property relating to our industry. From

time to time, third parties may claim that we are infringing upon their intellectual property rights, and we may be found to be infringing upon such rights. In the future, others may claim that our applications and underlying technology infringe or violate their intellectual property rights. However, we may be unaware of the intellectual property rights that others may claim cover some or all of our technology or services. Any claims or litigation could cause us to incur significant expenses and, if successfully asserted against us, could require that we pay substantial damages or ongoing royalty payments, prevent us from offering our services, or require that we comply with other unfavorable terms. We may also be obligated to indemnify our clients or business partners or pay substantial settlement costs, including royalty payments, in connection with any such claim or litigation and to obtain licenses, modify applications, or refund fees, which could be costly. Even if we were to prevail in such a dispute, any litigation regarding our intellectual property could be costly and time-consuming and divert the attention of our management and key personnel from our business operations.

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

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

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

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

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

Our products utilize certain software of third-party software developers. For example, we license technology from bswift as part of our Paylocity Enterprise Benefits solution. Although we believe that there are alternatives for these products, any significant interruption in the availability of such third-party software could have an adverse impact on our business unless and until we can replace the functionality provided by these products at a similar cost. Additionally, we rely, to a certain extent, upon such third parties' abilities to enhance their current products, to develop new products on a timely and cost-effective basis and to respond to emerging industry standards and other technological changes. We may be unable to replace the functionality provided by the third-party software currently offered in conjunction with our products in the event that such software becomes obsolete or incompatible with future versions of our products or is otherwise not adequately maintained or updated.

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

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

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

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

Changes in regulatory laws or requirements applicable to our software and services could impose increased costs on us, delay or prevent our introduction of new products and services, and impair the function or value of our existing products and services.

Our products and services may become subject to increasing regulatory requirements, and as these requirements proliferate, we may be required to change or adapt our products and services to comply. Changing regulatory requirements might render our products and services obsolete or might block us from developing new products and services. This might in turn impose additional costs upon us to comply or to further develop our products and services. It might also make introduction of new products and services more costly or more time-consuming than we currently anticipate. It might even prevent introduction by us of new products or services or cause the continuation of our existing products or services to become more costly. For example, the adoption of new money transmitter or money services business statutes in jurisdictions or changes in regulators’ interpretation of existing state and federal money transmitter or money services business statutes or regulations, could subject us to registration or licensing or limit business activities until we are appropriately licensed. These occurrences could also require changes to the manner in which we conduct some aspects of our business or invest client funds, which could adversely impact interest income from investing client funds. Should any state or federal regulators make a determination that we have operated as an unlicensed money services business or money transmitter, we could be subject to civil and criminal fines, penalties, costs, legal fees, reputational damage or other negative consequences. In addition, if the Affordable Care Act, or ACA, is repealed or modified in whole or in part, or if implementation of certain aspects of the ACA is delayed, such repeal, modification or delay could adversely impact the revenue we currently generate from our ACA Compliance solution as well as overall gross margins. Any of these regulatory implementations or changes could have an adverse effect on our business, operating results or financial condition.

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

We intend to continue to make investments to support our business growth and might require additional funds to respond to business challenges or opportunities, including the need to develop new products and services or enhance our existing services, enhance our operating infrastructure, and acquire complementary businesses and technologies.

Accordingly, we might need to engage in equity or debt financings to secure additional funds. In addition, we will need to expand our ACH capacity as we grow our business.

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

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

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

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

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

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

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

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

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

In addition, we have limited experience in acquiring other businesses. We may not be able to integrate the acquired personnel, operations and technologies successfully, or effectively manage the combined business following the

acquisition. We also may not achieve the anticipated benefits from the acquired business due to a number of factors, including:

- Inability to integrate or benefit from acquired technologies or services in a profitable manner;
- Unanticipated costs or liabilities associated with the acquisition;
- Incurrence of acquisition-related costs;
- Difficulty integrating the accounting systems, operations and personnel of the acquired business;
- Difficulties and additional expenses associated with supporting legacy products and hosting infrastructure of the acquired business;
- Difficulty converting the clients of the acquired business onto our applications and contract terms, including disparities in the revenues, licensing, support or professional services model of the acquired company;
- Diversion of management's attention from other business concerns;
- Adverse effects to our existing business relationships with business partners and clients as a result of the acquisition;
- The potential loss of key employees;
- Use of resources that are needed in other parts of our business; and
- Use of substantial portions of our available cash to consummate the acquisition.

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

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

Risks Related to Ownership of Our Common Stock

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

As of January 31, 2019, our directors, executive officers and holders of more than 5% of our common stock, together with their respective affiliates, beneficially owned, in the aggregate, approximately 38.6% of our outstanding common stock. This significant concentration of ownership may adversely affect the trading price for our common stock because investors often perceive disadvantages in owning stock in companies with controlling stockholders. In addition, these stockholders will be able to exercise influence over all matters requiring stockholder approval, including the election of directors and approval of corporate transactions, such as a merger or other sale of our company or its assets. This concentration of ownership could limit the ability of our other stockholders to influence corporate matters and may have the effect of delaying or preventing a change in control, including a merger, consolidation, or other business combination involving us, or discouraging a potential acquirer from making a tender offer or otherwise attempting to obtain control, even if that change in control would benefit our other stockholders.

Our stock price may be subject to wide fluctuations.

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

- Our operating performance and the operating performance of similar companies;
- Announcements by us or our competitors of acquisitions, business plans or commercial relationships;
- Any major change in our board of directors or senior management;
- Publication of research reports or news stories about us, our competitors, or our industry, or positive or negative recommendations or withdrawal of research coverage by securities analysts;
- The public’s reaction to our press releases, our other public announcements and our filings with the SEC;
- Sales of our common stock by our directors, executive officers and affiliates;
- Adverse market reaction to any indebtedness we may incur or securities we may issue in the future;
- Short sales, hedging and other derivative transactions in our common stock;
- Threatened or actual litigation;
- Other events or factors, including changes in general conditions in the United States and global economies or financial markets (including acts of God, war, incidents of terrorism, or other destabilizing events and the resulting responses to them).

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

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

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

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

As of January 31, 2019, we had an aggregate of 52,915,940 outstanding shares of common stock. The 17,362,750 shares sold in our initial public offering, follow-on offering and secondary offering can be freely sold in the public market without restriction. The remaining shares can be freely sold in the public market, subject in some cases to volume and other restrictions under Rule 144 and 701 under the Securities Act of 1933, as amended, and various agreements.

In addition, we have registered 17,853,893 shares of common stock that we have issued and may issue under our equity plans. These shares can be freely sold in the public market upon issuance, subject in some cases to volume and other restrictions under Rules 144 and 701 under the Securities Act, and various vesting agreements. In addition, some of our employees, including some of our executive officers, have entered into 10b5-1 trading plans regarding sales of shares of our common stock. These plans provide for sales to occur from time to time. If any of these additional shares are sold, or if it is perceived that they will be sold, in the public market, the trading price of our common stock could decline.

Also, in the future, we may issue additional securities in connection with investments and acquisitions. The amount of our common stock issued in connection with an investment or acquisition could constitute a material portion of our then outstanding stock. Due to these factors, sales of a substantial number of shares of our common stock in the public market could occur at any time. These sales, or the perception in the market that the holders of a large number of shares intend to sell shares, could reduce the market price of our common stock.

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

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

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

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

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

The trading market for our common stock depends in part on the research and reports that securities or industry analysts publish about us or our business. If one or more of the analysts who covers us downgrades our stock or publishes unfavorable or misleading research about our business, our stock price would likely decline. If one or more of

these analysts ceases coverage of our company or fails to publish reports on us regularly, we could lose visibility in the market for our stock and demand for our stock could decrease, which could cause our stock price or trading volume to decline.

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

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

- Authorize the issuance of “blank check” convertible preferred stock that could be issued by our board of directors to thwart a takeover attempt;
- Establish a classified board of directors, as a result of which the successors to the directors whose terms have expired will be elected to serve from the time of election and qualification until the third annual meeting following their election;
- Require that directors only be removed from office for cause and only upon a supermajority stockholder vote;
- Provide that vacancies on the board of directors, including newly-created directorships, may be filled only by a majority vote of directors then in office rather than by stockholders;
- Prevent stockholders from calling special meetings; and
- Prohibit stockholder action by written consent, requiring all actions to be taken at a meeting of the stockholders.

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

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

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

(a) Sales of Unregistered Securities

Not applicable.

(b) Use of Proceeds

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

million, paid \$9.4 million for the purchase of substantially all of the assets of BFKMS Inc. and paid \$9.5 million for the purchase of substantially all of the assets of Synergy Payroll, LLC.

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

On September 30, 2015, we completed a secondary offering of 4,301,000 shares of common stock at a price of \$29.75 per share, before underwriting discounts and commissions. The offer and sale of all of the shares in the secondary offering were registered under the Securities Act pursuant to a registration statement on Form S-3 (File No. 333-206941) which was declared effective by the SEC on September 25, 2015. The Company did not receive any proceeds from the sale of common stock, as all the shares were sold by shareholders of the Company.

Item 3. Defaults upon Senior Securities

None.

Item 4. Mine Safety Disclosures

Not applicable.

Item 5. Other Information

None.

Item 6. Exhibits

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

INDEX TO EXHIBITS

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

* Filed herewith

** Furnished herewith

SIGNATURES

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

PAYLOCITY HOLDING CORPORATION

Date: February 7, 2019

By: /s/ Steven R. Beauchamp

Name: Steven R. Beauchamp

Title: Chief Executive Officer (Principal Executive Officer) and Director

Date: February 7, 2019

By: /s/ Toby J. Williams

Name: Toby J. Williams

Title: Chief Financial Officer (Principal Financial Officer)

**CERTIFICATION OF CHIEF FINANCIAL OFFICER PURSUANT TO
SECTION 302(a) OF THE SARBANES-OXLEY ACT OF 2002**

I, Toby J. Williams, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Paylocity Holding Corporation (the "Company");
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
 - a. Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - b. Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - c. Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - d. Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's fiscal quarter ended December 31, 2018 that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
 - a. All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - b. Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: February 7, 2019

/s/ Toby J. Williams
 Name: Toby J. Williams
 Title: **Chief Financial Officer (Principal Financial Officer)**

**CERTIFICATION OF CHIEF EXECUTIVE OFFICER
PURSUANT TO 18 U.S.C. SECTION 1350
AS ADOPTED PURSUANT TO
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

The undersigned, the Chief Executive Officer of Paylocity Holding Corporation (the "Company"), does hereby certify under the standards set forth and solely for the purposes of 18 U.S.C. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that the Quarterly Report on Form 10-Q of the Company for the period ended December 31, 2018 fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934 and information contained in that Form 10-Q fairly presents, in all material respects, the financial condition and results of operations of the Company.

Dated: February 7, 2019

/s/ Steven R. Beauchamp
Steven R. Beauchamp
**Chief Executive Officer (Principal Executive Officer) and
Director**

A signed original of this written statement required by Section 906 has been provided to the Company and will be retained by the Company and furnished to the Securities and Exchange Commission or its staff upon request.

**CERTIFICATION OF CHIEF FINANCIAL OFFICER
PURSUANT TO 18 U.S.C. SECTION 1350
AS ADOPTED PURSUANT TO
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

The undersigned, the Chief Financial Officer of Paylocity Holding Corporation (the "Company"), does hereby certify under the standards set forth and solely for the purposes of 18 U.S.C. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that the Quarterly Report on Form 10-Q of the Company for the period ended December 31, 2018 fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934 and information contained in that Form 10-Q fairly presents, in all material respects, the financial condition and results of operations of the Company.

Dated: February 7, 2019

/s/ Toby J. Williams

Toby J. Williams
Chief Financial Officer (Principal Financial Officer)

A signed original of this written statement required by Section 906 has been provided to the Company and will be retained by the Company and furnished to the Securities and Exchange Commission or its staff upon request.
