TRINET GROUP INC
Form 10-Q
October 29, 2018

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, DC 20549

FORM 10-Q

(Mark One)

x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended September 30, 2018
or
o TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from to
Commission File Number: 001-36373

TRINET GROUP, INC.
(Exact Name of Registrant as Specified in its Charter)

Delaware	95-3359658
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
One Park Place, Suite 600, Dublin, CA	94568
(Address of principal executive offices)	(Zip Code)

Registrant's telephone number, including area code: (510) 352-5000

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

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, 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	x	Accelerated filer	o
Non-accelerated filer	o (do not check if a smaller reporting company)	Smaller reporting company	o
Emerging growth company o			

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. Yes o No o
Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes o No x
The number of shares of Registrant’s Common Stock outstanding as of October 22, 2018 was 70,444,420.

TRINET GROUP, INC.
Form 10-Q - Quarterly Report
For the Quarterly Period Ended September 30, 2018

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FORWARD LOOKING STATEMENTS AND OTHER FINANCIAL INFORMATION

Cautionary Note Regarding Forward-Looking Statements and Other Financial Information

For purposes of this Quarterly Report on Form 10-Q (Form 10-Q), the terms “TriNet,” “the Company,” “we,” “us” and “our” refer to TriNet Group, Inc., and its consolidated subsidiaries. This Form 10-Q contains statements that are not historical in nature, are predictive in nature, or that depend upon or refer to future events or conditions or otherwise contain forward-looking statements within the meaning of Section 21 of the Securities Exchange Act of 1934, as amended, and the Private Securities Litigation Reform Act of 1995. Forward-looking statements are often identified by the use of words such as, but not limited to, “anticipate,” “believe,” “can,” “continue,” “could,” “design,” “estimate,” “expe “forecast,” “hope,” “intend,” “may,” “outlook,” “plan,” “potential,” “predict,” “project,” “seek,” “should,” “strategy,” “target,” similar expressions or variations intended to identify forward-looking statements.

Forward-looking statements are not guarantees of future performance, but are based on management’s expectations as of the date of this Form 10-Q and assumptions that are inherently subject to uncertainties, risks and changes in circumstances that are difficult to predict. Forward-looking statements involve known and unknown risks, uncertainties and other factors that may cause actual results, performance or achievements to be materially different from our current expectations and any past results, performance or achievements. Given these risks and uncertainties, readers are cautioned not to place undue reliance on such forward-looking statements.

Important factors that could cause actual results to differ materially from those expressed or implied by these forward-looking statements are discussed throughout our Annual Report on Form 10-K for the year ended December 31, 2017 filed with the Securities and Exchange Commission (SEC) on February 27, 2018 (2017 Form 10-K), including those appearing under the heading “Risk Factors” in Item 1A, and under the heading “Management’s Discussion and Analysis of Financial Condition and Results of Operations” (MD&A) in Item 7 of our 2017 Form 10-K, as well as in our other periodic filings with the SEC. Those factors could cause our actual results to differ materially from our anticipated results. The information provided in this Form 10-Q is based upon the facts and circumstances known as of the date of this Form 10-Q, and any forward-looking statements made by us in this Form 10-Q speak only as of the date of this Form 10-Q. We undertake no obligation to revise or update any of the information provided in this Form 10-Q, except as required by law.

The MD&A of this Form 10-Q includes references to our performance measures presented in conformity with accounting principles generally accepted in the United States of America (GAAP) and other non-GAAP financial measures that we use to manage our business, to make planning decisions, to allocate resources and to use as performance measures in our executive compensation plans. Refer to the Non-GAAP Financial Measures in our Key Financial and Operating Metrics section within our MD&A for definitions and reconciliations from GAAP measures.

MANAGEMENT'S DISCUSSION
AND ANALYSIS

Management’s Discussion and Analysis of Financial Condition and Results of Operations

Executive Summary

Overview

TriNet is a leading provider of human resources (HR) solutions for small to midsize businesses (SMBs). Under our co-employment model, we assume certain of the responsibilities of being an employer and help our clients mitigate employer-related risks and manage many of the complex and burdensome administrative and compliance responsibilities associated with employment.

Our solutions include payroll processing, tax administration, access to employee benefits and an HR technology platform with online and mobile tools that allow our clients and worksite employees (WSEs) to store, view and manage their core HR-related information and efficiently conduct a variety of HR-related transactions anytime and anywhere.

Significant Developments in 2018

Our consolidated results for the nine months ended September 30, 2018 reflect continued progress in marketing and selling our industry-oriented (vertical) products and in our insurance service offerings, combined with higher WSE enrollment growth within our insurance offerings.

We experienced a decline in Average WSEs (defined as average monthly WSEs paid during the period) for the nine months ended September 30, 2018 as compared to the nine months ended September 30, 2017 primarily due to client attrition, including attrition from migrating certain of our clients from our legacy (SOI) platform onto our common TriNet platform, partially offset by growth in our other verticals.

In summary we:

- Launched TriNet Professional Services and completed the migration of existing clients from our SOI platform onto our common TriNet platform,
- Continued to invest in our efforts to enhance our clients' experience through operational and process improvements,
- Improved sales representative retention and launched a marketing and branding campaign in September 2018 to further augment our sales force efforts,
- Invested corporate funds to generate interest income and refinanced term loans during the second quarter of 2018,
- Continued to benefit from changes for one of our health insurance carrier contracts, where we converted from a guaranteed-cost to risk-based plan in late 2017,
- Continued to invest in improving our internal control environment to support our ongoing compliance with the requirements of the Sarbanes-Oxley Act of 2002 (SOX), and
- Received IRS designation as a Certified Professional Employer Organization on July 1, 2018 for a TriNet subsidiary.

MANAGEMENT'S DISCUSSION
AND ANALYSIS

Performance Highlights
Q3 2018
During the third quarter of 2018, we:

- Served approximately 16,400 clients and co-employed Average WSEs of approximately 318,000, a 2% decrease compared to the same period in 2017 and
- Processed approximately $8.7 billion in payroll and payroll tax payments for our clients, an increase of 8% compared to the same period in 2017.

Our financial highlights for the third quarter of 2018, compared to the same period in 2017, include:

- Total revenues increased 7% to $875 million and Net Service Revenues increased 11% to $228 million,
- Operating income decreased 1% to $62 million,
- Our effective income tax rate decreased to 16%,
- Net income increased 20% to $51 million, or $0.71 per diluted share and Adjusted Net Income increased 35% to $55 million, and
- Adjusted EBITDA increased 9% to $88 million.

YTD 2018
During the nine months ended September 30, 2018, we:

- Co-employed Average WSEs of approximately 315,500, a 3% decrease compared to the same period in 2017 and
- Processed approximately $27.4 billion in payroll and payroll tax payments for our clients, an increase of 6% compared to the same period in 2017.

Our financial highlights for the nine months ended September 30, 2018, compared to the same period in 2017, include:

- Total revenues increased 7% to $2.6 billion and Net Service Revenues increased 10% to $668 million,
- Operating income increased 24% to $209 million,
- Our effective income tax rate decreased to 18%,
- Net income increased 46% to $163 million, or $2.25 per diluted share and Adjusted Net Income increased 62% to $176 million, and
- Adjusted EBITDA increased 28% to $277 million.

MANAGEMENT'S DISCUSSION
AND ANALYSIS

Key Financial and Operating Metrics

The following key financial and operating metrics should be read in conjunction with our condensed consolidated financial statements and related notes included in this Form 10-Q.

	Three Months Ended September 30,			Nine Months Ended September 30,		
(in millions, except per share and WSE data)	2018	2017	% Change	2018	2017	% Change
Income Statement Data:						
Total revenues	$875	$818	7 %	$2,586	$2,427	7 %
Operating income	62	63	(1)	209	169	24
Net income	51	43	20	163	112	46
Diluted net income per share of common stock	0.71	0.60	18	2.25	1.57	43
Non-GAAP measures (1):						
Net Service Revenues	228	205	11	668	605	10
Net Insurance Service Revenues	109	93	17	305	264	15
Adjusted EBITDA	88	80	9	277	216	28
Adjusted Net Income	55	41	35	176	109	62
Operating Metrics:						
Total WSEs payroll and payroll taxes processed	$8,669	$8,061	8 %	$27,360	$25,835	6 %
Average WSEs	318,129	324,043	(2)	315,512	325,347	(3)

(1) Refer to Non-GAAP Financial Measures section below for definitions and reconciliations from GAAP measures.

	Nine Months Ended September 30,		%
(in millions, except operating metrics data)	2018	2017	Change
Operating Metrics:			
Total WSEs at period end	317,496	325,138	(2)%
Cash Flow Data:			
Net cash used in operating activities (1)	$(476)	$(141)	236
Net cash used in investing activities	(169)	(15)	1,045
Net cash used in financing activities	(62)	(65)	(4)

(1) Prior year balance has been retrospectively adjusted for Accounting Standards Update (ASU) 2016-18.

(in millions)	September 30, 2018	December 31, 2017	% Change
Balance Sheet Data:			
Cash and cash equivalents	$ 237	$ 336	(29) %
Working capital	226	234	(3)
Total assets	2,104	2,593	(19)
Notes payable	418	423	(1)
Total liabilities	1,754	2,387	(27)
Total stockholders’ equity	350	206	70

Non-GAAP Financial Measures

In addition to financial measures presented in accordance with GAAP, we monitor other non-GAAP financial measures that we use to manage our business, to make planning decisions, to allocate resources, and to use as performance measures in our executive compensation plan. These key financial measures provide an additional view of our operational performance over the long-term and provide useful information that we use in order to maintain and

grow our business.
The presentation of these non-GAAP financial measures is used to enhance the understanding of certain aspects of our financial performance. It is not meant to be considered in isolation from, superior to, or as a substitute, for the directly comparable financial measures prepared in accordance with GAAP.

MANAGEMENT'S DISCUSSION AND ANALYSIS

Non-GAAP Measure	Definition	How We Use The Measure
Net Service Revenues	• Sum of professional service revenues and Net Insurance Service Revenues, or total revenues less insurance costs.	• Provides a comparable basis of revenues on a net basis. Professional service revenues are represented net of client payroll costs whereas insurance service revenues are presented gross of insurance costs for financial reporting purposes. • Acts as the basis to allocate resources to different functions and evaluates the effectiveness of our business strategies by each business function. • Provides a measure, among others, used in the determination of incentive compensation for management.
Net Insurance Service Revenues	• Insurance revenues less insurance costs.	• Is a component of Net Service Revenues. • Provides a comparable basis of revenues on a net basis. Professional service revenues are represented net of client payroll costs whereas insurance service revenues are presented gross of insurance costs for financial reporting purposes. Promotes an understanding of our insurance services business by evaluating insurance service revenues net of our WSE related costs which are substantially pass-through for the benefit of our WSEs. Under GAAP, insurance service revenues and costs are recorded gross as we have latitude in establishing the price, service and supplier specifications. • We also sometimes refer to Net Insurance Service Margin, which is the ratio of Net Insurance Revenue to Insurance Service Revenue.
Adjusted EBITDA	• Net income, excluding the effects of: - income tax provision, - interest expense, - depreciation, - amortization of intangible assets, and - stock-based compensation expense.	• Provides period-to-period comparisons on a consistent basis and an understanding as to how our management evaluates the effectiveness of our business strategies by excluding certain non-cash charges such as depreciation and amortization, and stock-based compensation recognized based on the estimated fair values. We believe these charges are not directly resulting from our core operations or indicative of our ongoing operations. • Enhances comparisons to prior periods and, accordingly, facilitates the development of future projections and earnings growth prospects. • Provides a measure, among others, used in the determination of incentive compensation for management. • We also sometimes refer to Adjusted EBITDA margin, which is the ratio of Adjusted EBITDA to Net Service Revenue.
Adjusted Net Income	• Net income, excluding the effects of: - effective income tax rate (1), - stock-based compensation, - amortization of intangible assets, - non-cash interest expense (2), and - the income tax effect (at our effective tax rate (1)) of these pre-tax	• Provides information to our stockholders and board of directors to understand how our management evaluates our business, to monitor and evaluate our operating results, and analyze profitability of our ongoing operations and trends on a consistent basis by excluding certain non-cash charges.

adjustments.

(1) We have adjusted the non-GAAP effective tax rate to 26% for 2018 from 41% for 2017 due primarily to a decrease in the statutory rate from 35% to 21%. These non-GAAP effective tax rates exclude the income tax impact from stock-based compensation, changes in uncertain tax positions, and nonrecurring benefits or expenses from federal legislative changes.

(2) Non-cash interest expense represents amortization and write-off of our debt issuance costs.

MANAGEMENT'S DISCUSSION AND ANALYSIS

Reconciliation of GAAP to Non-GAAP Measures

The table below presents a reconciliation of Total revenues to Net Service Revenues:

	Three Months Ended September 30,		Nine Months Ended September 30,	
(in millions)	2018	2017	2018	2017
Total revenues	$875	$818	$2,586	$2,427
Less: Insurance costs	647	613	1,918	1,822
Net Service Revenues	$228	$205	$668	$605

The table below presents a reconciliation of Insurance service revenues to Net Insurance Service Revenues:

	Three Months Ended September 30,		Nine Months Ended September 30,	
(in millions)	2018	2017	2018	2017
Insurance service revenues	$756	$706	$2,223	$2,086
Less: Insurance costs	647	613	1,918	1,822
Net Insurance Service Revenues	$109	$93	$305	$264
Net Insurance Service Revenue Margin	14 %	13 %	14 %	13 %

The table below presents a reconciliation of Net income to Adjusted EBITDA:

	Three Months Ended September 30,		Nine Months Ended September 30,	
(in millions)	2018	2017	2018	2017
Net income	$51	$43	$163	$112
Provision for income taxes	9	15	36	44
Stock-based compensation	12	8	31	21
Interest expense and bank fees	5	5	17	15
Depreciation	10	8	26	20
Amortization of intangible assets	1	1	4	4
Adjusted EBITDA	$88	$80	$277	$216
Adjusted EBITDA Margin	38 %	39 %	41 %	36 %

The table below presents a reconciliation of Net income to Adjusted Net Income:

	Three Months Ended September 30,		Nine Months Ended September 30,	
(in millions)	2018	2017	2018	2017
Net income	$51	$43	$163	$112
Effective income tax rate adjustment	(6)	(8)	(16)	(19)
Stock-based compensation	12	8	31	21
Amortization of intangible assets	1	1	4	4
Non-cash interest expense	—	1	4	2

Income tax impact of pre-tax adjustments	(3)	(4)	(10)	(11)
Adjusted Net Income	$55	$41	$176	$109

Results of Operations

Operating Metrics

Worksite Employees (WSE)

Average WSE growth is a volume measure we use to monitor the performance of our business. Average WSEs decreased 2% in the third quarter of 2018 and decreased 3% in the nine months ended September 30, 2018, compared to the same respective periods in 2017. The declines in Average WSEs during the third quarter and nine months ended September 30, 2018 compared to the same periods in 2017 were the result of attrition, including attrition from migrating certain of our clients to our common platform, partially offset by WSE growth due to new sales and hiring within our installed base.

Total WSE, defined as WSEs paid at period end, comparisons have served as an indicator of our success in growing our business and retaining clients. Anticipated revenues for future periods can diverge from Total WSEs due to pricing differences across our HR solutions and insurance service offerings and the degree to which clients and WSEs elect to participate in our solutions.

MANAGEMENT'S DISCUSSION
AND ANALYSIS

Revenues and Income

Our revenues consist of professional service revenues (PSR) and insurance service revenues (ISR). PSR represent fees charged to clients for processing payroll-related transactions on behalf of our clients, access to our HR expertise, employment and benefit law compliance services, and other HR-related services. ISR consist of insurance-related billings and administrative fees collected from clients and withheld from WSEs for workers' compensation insurance and health benefit insurance plans provided by third-party insurance carriers.
In addition to focusing on growing our Average WSE and Total WSE counts, we also focus on pricing strategies and product differentiation to expand our revenue opportunities. Monthly total revenues per Average WSE, as a measure to monitor the success of such strategies, increased 9% in the third quarter of 2018 and increased 10% in the nine months ended September 30, 2018 compared to the same periods in 2017, respectively.

Q3 2018 - Q3 2017 Commentary
Total revenues were $875 million for the third quarter of 2018, a 7% increase compared to the same period in 2017.

- PSR increased 6% compared to the same quarter in 2017 to $119 million due primarily to rate increases.
- ISR increased 7% compared to the same quarter in 2017 to $756 million due primarily to an increase in WSEs electing to participate in our insurance services.

Operating income was $62 million in the third quarter of 2018, a decrease of $1 million or 1% compared to the third quarter of 2017, primarily as a result of:

- an increase of $22 million in other operating expenses (OOE) which includes $10 million of anticipated costs associated with our marketing campaign and additional investment in operational and process improvements,
- partially offset by an increase of $23 million in total revenues less insurance costs due to:
- favorable experience from the change in the economic arrangement with one of our carriers from a guaranteed cost contract to a risk-based contract, and
- favorable experience with other risk-based contracts, including favorable prior period development of $4 million in workers' compensation insurance costs.

MANAGEMENT'S DISCUSSION
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YTD 2018 - YTD 2017 Commentary

Total revenues were $2.6 billion for the nine months ended September 30, 2018, a 7% increase compared to the same period in 2017.

- PSR increased 6% compared to the same period in 2017 to $363 million due to rate increases and changes in vertical mix partially offset by a reduction in Average WSEs.
- ISR increased 7% compared to the same period in 2017 to $2.2 billion due primarily to an increase in WSEs electing to participate in our insurance services.

Operating income was $209 million, in the nine months ended September 30, 2018, up $40 million or 24% compared to the nine months ended September 30, 2017, primarily as a result of:

- An increase of $63 million in total revenues less insurance costs due to:
- favorable experience from the change in the economic arrangement of one of our health insurance contracts as noted above, and
- favorable experience with other risk-based contracts, including favorable prior period development of $17 million in workers' compensation insurance costs,
- partially offset by an increase of $17 million in OOE, which includes $10 million of anticipated costs associated with our marketing campaign and additional investment in operational and process improvements.

Net Service Revenues

Net Service Revenues (total revenues less insurance costs) provide a comparable basis of revenues on a net basis, act as the basis to allocate resources to different functions, and help us evaluate the effectiveness of our business strategies by each business function.

Q3 2018 - Q3 2017 Commentary

Net Service Revenues were $228 million for the third quarter of 2018, representing an 11% increase compared to the same period in 2017. This increase is primarily due to an increase in Net Insurance Service Revenues from changes in the composition of our enrolled WSEs within our insurance offerings (ISR mix) partially offset by health plan participation costs (insurance cost mix). Additionally, Monthly Net Service Revenues per Average WSE increased 13% over the same period in 2017.

YTD 2018 - YTD 2017 Commentary

Net Service Revenues were $668 million for the nine months ended September 30, 2018, representing a 10% increase compared to the same period in 2017. This increase is primarily due to an increase in Net Insurance Service Revenues from changes in the composition of our enrolled WSEs within our insurance offerings (ISR mix) partially offset by health plan participation costs (insurance cost mix). Additionally, Monthly Net Service Revenues per Average WSE increased 14% over the same period in 2017.

Professional Service Revenues (PSR)

Our clients are billed either based on a fee per WSE per month per transaction or on a percentage of the WSEs' payroll. For those clients that are billed on a percentage of WSEs' payroll, as our clients' payrolls increase, our fees also increase. As such, payroll and payroll taxes processed may also be an indicator of our PSR growth.

Our investment in a vertical approach provides us the flexibility to offer our clients in different industries with varied services at different prices. We believe that this vertical approach will improve our ability to retain our customers, and potentially reduce the value of using WSEs as the only leading indicator of future revenue performance. During the nine months ended September 30, 2018, we have seen a client base (mix) change with increased attrition in our Main Street vertical, partially offset by new sales in other verticals, primarily our technology and financial services verticals.

We present the percentage changes in PSR using the following measures:

- Volume - the percentage change in period over period Average WSEs,
- Rate - the percentage changes in prices for each vertical, and
- Mix - the change in composition of Average WSEs within our verticals.

MANAGEMENT'S DISCUSSION
AND ANALYSIS

Insurance Service Revenues (ISR)

ISR consists of insurance services-related billings and administrative fees collected from clients and withheld from WSE payroll for health benefits and workers' compensation insurance provided by third-party insurance carriers.

We present the percentage changes in ISR using the following measures:

- Volume - the percentage change in period over period Average WSEs,
- Rate - the percentage changes in prices associated with each of our insurance service offerings, and
- Mix - all other changes including the composition of our enrolled WSEs within our insurance service offerings.

MANAGEMENT'S DISCUSSION
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Insurance Costs

Insurance costs include insurance premiums for coverage provided by insurance carriers, reimbursement of claims payments made by insurance carriers or third-party administrators, and changes in loss reserves related to contractual obligations with our workers' compensation and health benefit carriers.

We present the percentage changes in insurance costs using the following measures:

- Volume - the percentage change in period over period Average WSEs,
- Rate - the percentage changes in cost trend associated with each of our insurance service offerings, and
- Mix - all other changes including the composition of our enrolled WSEs within our insurance offerings.

Other Operating Expenses (OOE)

Other operating expenses includes cost of providing services (COPS), sales and marketing (S&M), general and administrative (G&A), and systems development and programming (SD&P) expenses. Other operating expenses excludes depreciation and amortization expenses.

We manage and monitor our other operating expenses and allocate resources across different business functions based on OOE as a percentage of Net Service Revenues which increased to 68% in the third quarter of 2018 from 65% in the same period in 2017 and decreased to 64% in the nine months ended September 30, 2018 from 68% in the same period in 2017.

At September 30, 2018, we had approximately 2,900 corporate employees in 53 offices across the United States. Our corporate employees' compensation related expenses represent the majority of our operating expenses. Compensation costs for our corporate employees include payroll, payroll taxes, stock-based compensation, bonuses, commissions and other payroll and benefits related costs.

The percentage of compensation related expenses to OOE was 65% and 62% in the third quarters of 2018 and 2017, respectively, and increased to 66% in the nine months ended September 30, 2018 from 64% in the same period in 2017. The increases for the third quarter of 2018 and the nine months ended September 30, 2018 when compared to the same periods in 2017 are due to increased headcount intended to enhance our clients' experience through operational and process improvements.

OOE for third quarter and year to date 2018 includes approximately $10 million of anticipated costs associated with our marketing campaign and additional investments in operational and process improvements. We expect our OOE to increase in the foreseeable future due to expected growth, our continued strategy to develop new vertical products, and additional costs associated with our continued efforts to improve our systems, processes, and internal controls. These expenses may fluctuate as a percentage of our total revenues from period-to-period depending on the timing of when expenses are incurred.

MANAGEMENT'S DISCUSSION
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Q3 2018 - Q3 2017 Commentary

Other operating expenses were $155 million for the third quarter of 2018, an increase of $22 million compared to the same period in 2017. Specific costs varied as follows:

Total compensation costs increased $18 million, or 21%, primarily due to:

an increase of $24 million due primarily to increased headcount in various customer service functions and general administrative functions to support process improvement initiatives,

partially offset by a decrease of $6 million in commission expense with the adoption of ASC Topic 606 in the first quarter of 2018. Refer to Note 1 in Item 1 of this Form 10-Q for additional details surrounding the impact of this adoption.

Marketing costs increased $5 million due to the launch of our new marketing and branding campaign.

YTD 2018 - YTD 2017 Commentary

Other operating expenses were $429 million for the nine months ended September 30, 2018, an increase of $17 million compared to the same period in 2017. Specific costs varied as follows:

Total compensation costs increased $21 million, or 8%, primarily due to an increase of $42 million resulting from additional headcount, offset by a decrease of $21 million in commission expense.

Other Income (Expense)

Other income (expense) in the third quarter of 2018 and the nine months ended September 30, 2018 decreased $3 million compared to the same periods in 2017. Specific income (expense) items for the third quarter of 2018 and nine months ended September 30, 2018 varied as follows:

- For the third quarter of 2018, interest and dividend income increased $2 million due to an increase in yields from investing activities we initiated in the second quarter of 2018 in an effort to maximize return on our cash balances.
- For the nine months ended September 30, 2018, interest and dividend income increased $6 million due to an increase in yields from investing activities, partially offset by $2 million increase in interest expense associated with the write-off of debt issuance costs related to the refinancing of our previous terms loans, as compared to the same period in 2017.

Provision for Income Taxes

Our effective income tax rate was 16% and 26% for the three months ended September 30, 2018 and 2017, respectively, and 18% and 28% for the nine months ended September 30, 2018 and 2017, respectively. These decreases are primarily due to a reduction in the federal corporate income tax rate from 35% to 21% under the Tax Cuts and Jobs Act (TCJA), additional tax benefits from a decrease in uncertain tax positions, an increase in tax credits and an increase in excludable income for state tax purposes. These benefits are partially offset by a decrease in excess tax benefits related to stock-based compensation and a one-time qualified production activities deduction for certain software offerings recorded in the prior year.

MANAGEMENT'S DISCUSSION
AND ANALYSIS

Liquidity and Capital Resources

Liquidity

We report our liquidity separately between WSE-related assets and liabilities and our corporate assets and liabilities. We believe that we have sufficient liquidity and capital resources to satisfy future requirements and meet our obligations to our clients, creditors and debt holders. Our liquid assets are as follows:

	September 30, 2018			December 31, 2017		
(in millions)	Corporate	WSE	Total	Corporate	WSE	Total
Current assets						
WSE-related assets	$—	$403	$403	$—	$360	$360
Cash and cash equivalents	237	—	237	336	—	336
Restricted cash, cash equivalents and investments	15	606	621	15	1,265	1,280
All other current assets	76	—	76	15	—	15
Current assets	$328	$1,009	$1,337	$366	$1,625	$1,991
Current liabilities						
WSE-related liabilities	$—	$1,009	$1,009	$—	$1,618	$1,618
All other current liabilities	102	—	102	139	—	139
Current liabilities	$102	$1,009	$1,111	$139	$1,618	$1,757
Working capital	$226	$—	$226	$227	$7	$234

Working capital for WSE-related assets and liabilities

We present our WSE-related assets and liabilities separately from our corporate assets and liabilities on our condensed consolidated balance sheets to better distinguish those assets and liabilities held by us to satisfy WSE-related obligations. WSE-related assets and liabilities primarily consist of current assets and current liabilities, respectively, resulting from transactions directly or indirectly associated with WSEs, including payroll and related taxes and withholdings, our sponsored insurance programs, and other benefit programs.

We designate funds to ensure that we have adequate current assets to satisfy our current WSE-related obligations. We manage our WSE payroll and benefits obligations through collections of payments from our clients which generally occurs two to three days in advance of the client's payroll date. We regularly review our short-term WSE-related obligations (such as payroll and related taxes, insurance premium and claim payments) and designate funds required to fulfill these short-term obligations, which we refer to as payroll funds collected (PFC). PFC is included in current assets as restricted cash, cash equivalents and investments in our condensed consolidated financial statements.

We manage our sponsored benefit and workers' compensation insurance obligations by maintaining collateral funds in restricted cash, cash equivalents and investments. These collateral amounts are generally determined at the beginning of each plan year and we may be required by our insurance carriers to adjust the balance when facts and circumstances change. We regularly review our collateral balances with our insurance carriers and anticipate funding further collateral based upon our capital requirements. We classify our restricted cash, cash equivalents and investments as current and noncurrent assets to match against the anticipated payment of claims.

MANAGEMENT'S DISCUSSION
AND ANALYSIS

Working capital for corporate purposes

We use the remaining available cash and cash equivalents and cash from operations to satisfy our operational and regulatory requirements and to fund capital expenditures. We believe that our existing corporate cash and cash equivalents and positive working capital will be sufficient to meet our working capital and capital expenditure needs for at least the next 12 months. Corporate working capital as of September 30, 2018 remained flat compared to December 31, 2017.

Capital Resources

Sources of Funds

We believe that we can meet our present and reasonably foreseeable operating cash needs and future commitments through existing liquid assets, continuing cash flows from operations, our borrowing capacity under our revolving credit facility and the potential issuance of debt or equity securities through our filed shelf registration statement.

In June 2018 we refinanced approximately $415 million of, and repaid in full, our outstanding A and A-2 term loans (together, our 2014 Term Loans) under our previous credit agreement (our 2014 Credit Agreement). Our 2014 Term Loans were replaced with a $425 million term loan A (our 2018 Term Loan) under our new credit agreement (our 2018 Credit Agreement). We also replaced our previous $75 million revolving credit facility established under our 2014 Credit Agreement with a $250 million revolving credit facility under our 2018 Credit Agreement (our 2018 Revolver), which will be used solely for working capital and other general corporate purposes.

Each of our 2018 Term Loan and our 2018 Revolver mature in June 2023 and bear interest, at our option, either at a LIBOR rate, or the prime lending rate, plus an applicable margin subject to change in the future based on our leverage ratio, as set forth in our 2018 Credit Agreement. As of September 30, 2018, $420 million was outstanding under our 2018 Term Loan and the full amount of our 2018 Revolver, less approximately $16 million representing an undrawn letter of credit, was available.

Cash Flows

In January 2018, we adopted ASU 2016-18 Statement of Cash Flows (Topic 230): Restricted Cash, which significantly impacted our net cash provided by (used in) operating activities as changes in our restricted cash and cash equivalents balances are no longer included within operating cash activities.

The following table presents our cash flow activities for the stated periods:

	Nine Months Ended September 30,					
(in millions)	2018			2017		
	Corporate	WSE	Total	Corporate	WSE	Total
Net cash provided by (used in):						
Operating activities [1]	$184	$(660)	$(476)	$205	$(346)	$(141)
Investing activities	(169)	—	(169)	(15)	—	(15)
Financing activities	(62)	—	(62)	(65)	—	(65)
Net increase (decrease) in cash and cash equivalents, unrestricted and restricted	$(47)	$(660)	$(707)	$125	$(346)	$(221)
Cash and cash equivalents, unrestricted and restricted:						
Beginning of period	$476	$1,262	$1,738	$278	$955	$1,233
End of period	$429	$602	$1,031	$403	$609	$1,012
Net increase (decrease) in cash and cash equivalents:						
Unrestricted	$(99)	$—	$(99)	$80	$—	$80
Restricted	52	(660)	(608)	45	(346)	(301)

(1) Prior year balances were retrospectively adjusted for Accounting Standards Update (ASU) 2016-18.

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MANAGEMENT'S DISCUSSION AND ANALYSIS

Operating Activities

Components of net cash used in operating activities are as follows:

	Nine Months Ended September 30,					
(in millions)	2018			2017		
	Corporate	WSE	Total	Corporate	WSE	Total
Net income	$163	$—	$163	$112	$—	$112
Depreciation and amortization	36	—	36	26	—	26
Stock-based compensation expense	31	—	31	21	—	21
Payment of interest	(13)	—	(13)	(12)	—	(12)
Income tax payments, net	(33)	—	(33)	—	—	—
Collateral paid to insurance carriers, net	(1)	—	(1)	(3)	—	(3)
Changes in other operating assets	10	(51)	(41)	33	(5)	28
Changes in other operating liabilities	(9)	(609)	(618)	28	(341)	(313)
Net cash provided by (used in) operating activities [1]	$184	$(660)	$(476)	$205	$(346)	$(141)

(1) Prior year balances were retrospectively adjusted for Accounting Standards Update (ASU) 2016-18.

Net cash used in operating activities from WSE-related activities was primarily driven by the timing of client payments, payroll amounts, collateral funding and insurance claim activities. Cash used in operating activities for WSE purposes increased by $314 million during the nine months ended September 30, 2018, compared to the same period in 2017, and was primarily driven by payments of payroll taxes and related liabilities. We expect the changes in restricted cash and cash equivalents to correspond to WSE cash provided by (or used in) operations as we manage our WSE-related obligations through restricted cash.

Cash provided by corporate operating activities decreased $21 million in the first nine months of 2018 compared to the same period in 2017 and was driven by the timing of corporate income tax payments as well as payments to vendors. The overall decrease was partially offset by a 46% increase in our net income.

We expect our tax payments to continue to increase in 2018 due to our inability to defer taxes as a result of new restrictions in the TCJA.

Investing Activities

Net cash used in investing activities in the nine months ended September 30, 2018 and 2017, respectively, primarily consisted of purchases of investments partially offset by proceeds from the sale and maturity of restricted investments, and cash paid for capital expenditures.

	Nine Months Ended September 30,	
(in millions)	2018	2017
Investments:		
Purchases of investments	$223	$—
Proceeds from sale of investments	(54)	—
Proceeds from maturity of investments	(33)	(14)
Cash used in investments	$136	$(14)
Capital expenditures:		
Software and hardware	$21	$23

Office furniture, equipment and leasehold improvements	12	6
Cash used in capital expenditures	$33	$29

MANAGEMENT'S DISCUSSION
AND ANALYSIS

Investments

During the nine months ended September 30, 2018, we invested a portion of available cash in investment-grade securities with effective maturities less than five years that are classified on our balance sheet as investments. As of September 30, 2018, we had approximately $168 million in investments.

We also invest funds held as collateral to satisfy our long-term obligation towards workers' compensation liabilities in U.S. long-term treasuries. These investments are classified on our balance sheet included as restricted cash, cash equivalents and investments. We review the amount and the anticipated holding period of these investments regularly in conjunction with our estimated long-term workers' compensation liabilities and anticipated claims payment trend. As of September 30, 2018, we held approximately $802 million of restricted cash, cash equivalents and investments in noncurrent and current accounts, of which approximately $5 million is in U.S. long-term treasuries.

As of September 30, 2018, we held approximately $1.2 billion in cash, cash equivalents and investments. Refer to Note 2 in Item 1 in this Form 10-Q for a summary of these funds.

Capital Expenditures

During the nine months ended September 30, 2018 and 2017, we continued to make investments in software and hardware, enhanced existing products and platforms, and implemented legacy platform migrations. We also incurred expenses related to the build out of our corporate headquarters and our technology and client service centers. We expect capital investments in our software and hardware to continue in the future.

Financing Activities

Net cash used in financing activities in the nine months ended September 30, 2018 and 2017 consisted of our debt and equity related activities.

(in millions)	Nine Months Ended September 30, 2018	2017
Financing activities		
Repurchase of common stock, net of issuance	$ 53	$ 36
Repayment of borrowings	15	29
Net proceeds from issuance of notes payable	(6)	—
Cash used in financing activities	$ 62	$ 65

In the nine months ended September 30, 2018 we refinanced our 2014 Term Loans with our 2018 Term loan as discussed above. For additional information refer to Note 7 in item 1 of this Form 10-Q.

Our board of directors authorizes common stock repurchases through an ongoing program initiated in May 2014, primarily to offset dilution from the issuance of stock under our equity-based incentive plan and employee stock purchase plan. During the nine months ended September 30, 2018, we repurchased 895,699 shares of our common stock for approximately $47 million through our stock repurchase program. As of September 30, 2018, approximately $90 million remained available for repurchase under all authorizations by our board of directors.

Covenants

Our 2018 Credit Agreement contains customary representations and warranties and customary affirmative and negative covenants applicable to us, including, among other things, restrictions on indebtedness, liens, investments, mergers, dispositions, prepayment of indebtedness (other than our 2018 Term Loan and our 2018 Revolver), dividends, distributions and transactions with affiliates. It also contains financial covenants requiring us to maintain certain minimum interest coverage and maximum total leverage ratios, as set forth in our 2018 Credit Agreement. These covenants took effect on June 30, 2018. We were in compliance with these financial covenants under the credit facilities at September 30, 2018. For more details on the covenants under our 2018 Credit Agreement, refer to Note 7 in Item 1 of this Form 10-Q.

MANAGEMENT'S DISCUSSION
AND ANALYSIS

Contractual Obligations

The following table summarizes our significant contractual obligations associated with our debt refinance at September 30, 2018:

	Payments Due by Period			
(in millions)	Total	Less than 1 year	1-3 years	3-5 years
Debt obligations (1)	$489	$ 38	$ 74	$ 377

(1) Includes principal and the projected interest payments of our term loans, refer to Note 7 in Item 1 of this Form 10-Q for details.

Off-Balance Sheet Arrangements

There has been no material change in our off-balance sheet arrangements discussed in Item 7 of our 2017 Form 10-K.

Critical Accounting Policies, Estimates and Judgments

During the first quarter of 2018, we adopted ASC Topic 606. Refer to Note 1 in Item 1 of this Form 10-Q for disclosure of the changes related to this adoption. There have been no additional material changes to our critical accounting policies as discussed in our 2017 Form 10-K.

Recent Accounting Pronouncements

Refer to Note 1 in Item 1 of this Form 10-Q.

QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK AND CONTROLS AND PROCEDURES

Quantitative and Qualitative Disclosures About Market Risk

Our exposure to changes in interest rates relates primarily to our investment portfolio and outstanding floating rate debt. Changes in U.S. interest rates affect the interest earned on the Company's cash, cash equivalents and investments and the fair value of the investments, as well as interest costs associated with our debt.

In the first quarter of 2018 our board of directors approved a corporate investment policy that defines our investable cash in instruments that meet certain credit quality, liquidity, diversification and other requirements. We believe that our exposure to losses resulting from credit risk is not significant. A sensitivity analysis to determine the impact a change in interest rates would have on the value of the investment portfolio assuming a 100 basis point parallel shift in the yield curve. Based on investment positions as of September 30, 2018, a hypothetical 100 basis point increase or decrease in interest rates across all maturities would result in a $2 million incremental increase or decrease in the fair market value of the portfolio, respectively. Such losses would only be realized if we sold the investments prior to maturity. The risk of rate changes on investment balances was not significant at September 30, 2018.

In June 2018, we refinanced our term loans which would have matured in July 2019 and replaced them with a term loan maturing in 2023. At September 30, 2018, after this refinancing, we had total outstanding indebtedness of $420 million, of which $22 million is due within 12 months. A 100 basis point increase or decrease in market interest rates would cause interest expense on our debt as of September 30, 2018 to increase or decrease by $4 million on an annualized basis, respectively.

Controls and Procedures

Evaluation of Disclosure Controls and Procedures

We have, with the participation of our Chief Executive Officer (CEO) and our Chief Financial Officer (CFO), evaluated the effectiveness of our disclosure controls and procedures as of September 30, 2018. The term "disclosure controls and procedures," as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended, or the Exchange Act, means controls and other procedures of a company 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 information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is accumulated and communicated to the company's management, including its principal executive officer and principal financial officer, as appropriate to allow timely decisions regarding required disclosure. Based on the evaluation of our disclosure controls and procedures as of September 30, 2018, our CEO and CFO concluded that, as of such date, our disclosure controls and procedures were not effective as a result of a material weakness in our internal control over financial reporting. A material weakness is a deficiency, or a combination of deficiencies, in internal control over financial reporting such that there is a reasonable possibility that a material misstatement of our annual or interim financial statements will not be prevented or detected on a timely basis.

Notwithstanding the material weakness in our internal control over financial reporting, we have concluded that the condensed consolidated financial statements included in this Quarterly Report on Form 10-Q fairly present, in all material respects, our financial position, results of operations and cash flows for the periods presented in conformity with accounting principles generally accepted in the United States of America. Additionally, the material weakness did not result in any restatements of our condensed consolidated financial statements or disclosures for any prior period.

Additional Analyses and Procedures and Remediation Plan

We are taking specific steps to remediate the material weakness identified by management and described in greater detail in our 2017 Form 10-K. Although we intend to complete the remediation process with respect to this material weakness as quickly as possible, we cannot at this time estimate how long it will take, and our remediation plan may not prove to be successful.

Because the reliability of the internal control process requires repeatable execution, the successful remediation of this material weakness will require review and evidence of effectiveness prior to concluding that the controls are effective and there is no assurance that additional remediation steps will not be necessary. As such, as we continue to evaluate and work to improve our internal control over financial reporting, our management may decide to take additional measures to address the material weaknesses or modify the remediation steps already underway. As noted above, although we plan to complete the remediation process as quickly as possible, we cannot at this time estimate how long it will take, and our initiatives may not prove to be successful. Accordingly, until this weakness is remediated, we plan to perform additional analyses and other procedures to ensure that our condensed consolidated financial statements are prepared in accordance with GAAP.

Changes in Internal Control Over Financial Reporting

Other than the material weakness remediation efforts underway, there were no changes in our internal control over financial reporting identified in connection with the evaluation required by Rule 13a-15(d) and 15d-15(d) of the Exchange Act that occurred during the quarter ended September 30, 2018, that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Limitations on Effectiveness of Controls and Procedures

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

FINANCIAL STATEMENTS

CONDENSED CONSOLIDATED BALANCE SHEETS (Unaudited)

(in millions, except share and per share data)	September 30, 2018		December 31, 2017	
Assets				
Current assets:				
Cash and cash equivalents		$237		$336
Investments		38		—
Restricted cash, cash equivalents and investments		621		1,280
Worksite employee related assets:				
Unbilled revenue (net of advance collections of $39 and $12 at September 30, 2018 and December 31, 2017, respectively)	$306		$297	
Accounts receivable	5		20	
Prepaid insurance premiums and other insurance related receivables (net of health benefit loss reserves of $45 and $0 at September 30, 2018 and December 31, 2017, respectively	47		26	
Other payroll assets	45		17	
Worksite employee related assets		403		360
Prepaid expenses and other current assets		38		15
Total current assets		1,337		1,991
Investments, noncurrent		130		—
Restricted cash, cash equivalents and investments, noncurrent		181		162
Workers' compensation collateral receivable		40		39
Property and equipment, net		78		70
Goodwill and other intangible assets, net		311		315
Other assets		27		16
Total assets		$2,104		$2,593
Liabilities and stockholders' equity				
Current liabilities:				
Accounts payable and other current liabilities		$43		$59
Accrued corporate wages		37		40
Notes payable		22		40
Worksite employee related liabilities:				
Accrued wages	$326		$289	
Client deposits	35		52	
Payroll tax liabilities and other payroll withholdings	419		1,034	
Health benefits loss reserves (net of prepayments of $0 and $19 at September 30, 2018 and December 31, 2017, respectively)	144		151	
Workers' compensation loss reserves (net of collateral paid of $4 and $6 at September 30, 2018 and December 31, 2017, respectively)	68		67	
Insurance premiums and other payables	17		25	
Worksite employee related liabilities		1,009		1,618
Total current liabilities		1,111		1,757
Notes payable, noncurrent		396		383
Workers' compensation loss reserves (net of collateral paid of $14 and $17 at September 30, 2018 and December 31, 2017, respectively)		159		165
Deferred income taxes		72		68
Other liabilities		16		14
Total liabilities		1,754		2,387

Commitments and contingencies (see Note 10)		
Stockholders' equity:		
Preferred stock		
($0.000025 par value per share; 20,000,000 shares authorized; no shares issued and outstanding at September 30, 2018 and December 31, 2017)	—	—
Common stock and additional paid-in capital		
($0.000025 par value per share; 750,000,000 shares authorized; 70,508,389 and 69,818,392 shares issued and outstanding at September 30, 2018 and December 31, 2017, respectively)	623	583
Accumulated deficit	(273)	(377)
Total stockholders' equity	350	206
Total liabilities and stockholders' equity	$ 2,104	$ 2,593

See accompanying notes.

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FINANCIAL STATEMENTS

CONDENSED CONSOLIDATED STATEMENTS OF INCOME AND COMPREHENSIVE INCOME
(Unaudited)

(in millions, except share and per share data)	Three Months Ended September 30, 2018	Three Months Ended September 30, 2017	Nine Months Ended September 30, 2018	Nine Months Ended September 30, 2017
Professional service revenues	$119	$ 112	$363	$ 341
Insurance service revenues	756	706	2,223	2,086
Total revenues	875	818	2,586	2,427
Insurance costs	647	613	1,918	1,822
Cost of providing services (exclusive of depreciation and amortization of intangible assets)	58	50	166	157
Sales and marketing	52	44	132	139
General and administrative	33	28	95	82
Systems development and programming	12	11	36	34
Depreciation	10	8	26	20
Amortization of intangible assets	1	1	4	4
Total costs and operating expenses	813	755	2,377	2,258
Operating income	62	63	209	169
Other income (expense):				
Interest expense, bank fees and other, net	(2)	(5)	(10)	(13)
Income before provision for income taxes	60	58	199	156
Income tax expense	9	15	36	44
Net income	$51	$ 43	$163	$ 112
Comprehensive income	$51	$ 43	$163	$ 112
Net income per share:				
Basic	$0.73	$ 0.62	$2.32	$ 1.62
Diluted	$0.71	$ 0.60	$2.25	$ 1.57
Weighted average shares:				
Basic	70,556,897	69,498,218	70,353,690	69,016,054
Diluted	72,599,714	71,499,591	72,388,751	71,138,743

See accompanying notes.

FINANCIAL STATEMENTS

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)

	Nine Months Ended September 30,	
(in millions)	2018	2017
Operating activities		
Net income	$163	$112
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	36	26
Stock-based compensation	31	21
Changes in operating assets and liabilities:		
Prepaid income taxes	1	42
Prepaid expenses and other current assets	(24)	(1)
Workers' compensation collateral receivable and other noncurrent assets	(10)	(7)
Accounts payable and other current liabilities	(9)	7
Accrued corporate wages	(4)	1
Workers' compensation loss reserves and other noncurrent liabilities	—	4
Worksite employee related assets	(51)	(5)
Worksite employee related liabilities	(609)	(341)
Net cash used in operating activities	(476)	(141)
Investing activities		
Purchases of marketable securities	(223)	—
Proceeds from sale of marketable securities	54	—
Proceeds from maturity of marketable securities	33	14
Acquisitions of property and equipment	(33)	(29)
Net cash used in investing activities	(169)	(15)
Financing activities		
Repurchase of common stock	(47)	(39)
Proceeds from issuance of common stock on exercised options	6	9
Proceeds from issuance of common stock on employee stock purchase plan	3	2
Awards effectively repurchased for required employee withholding taxes	(15)	(8)
Proceeds from issuance of notes payable, net	210	—
Payments for extinguishment of debt	(204)	—
Repayment of notes payable	(15)	(29)
Net cash used in financing activities	(62)	(65)
Net decrease in cash and cash equivalents, unrestricted and restricted	(707)	(221)
Cash and cash equivalents, unrestricted and restricted:		
Beginning of period	1,738	1,233
End of period	$1,031	$1,012
Supplemental disclosures of cash flow information		
Interest paid	$13	$12
Income taxes paid, net	33	—
Supplemental schedule of noncash investing and financing activities		
Payable for purchase of property and equipment	$2	$2
Supplemental schedule of cash and cash equivalents		
Net increase (decrease) in unrestricted cash and cash equivalents	$(99)	$80

Net decrease in restricted cash and cash equivalents	(608)	(301)

See accompanying notes.

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FINANCIAL STATEMENTS

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)
NOTE 1. DESCRIPTION OF BUSINESS AND SIGNIFICANT ACCOUNTING POLICIES
Description of Business
TriNet Group, Inc. (TriNet, or the Company, we, our and us), a professional employer organization (PEO) founded in 1988, provides comprehensive human resources (HR) solutions for small to midsize businesses (SMBs) under a co-employment model. These HR solutions include bundled services, such as multi-state payroll processing and tax administration, employee benefits programs, including health insurance and retirement plans, workers' compensation insurance and claims management, employment and benefit law compliance, and other services. Through the co-employment relationship, we are the employer of record for most administrative and regulatory purposes, including:

- compensation through wages and salaries,
- employer payroll-related tax payments,
- employee payroll-related tax withholdings and payments,
- employee benefit programs including health and life insurance, and others, and
- workers' compensation coverage.

Our clients are responsible for the day-to-day job responsibilities of the worksite employees (WSEs).

We operate in one reportable segment. All of our service revenues are generated from external clients. Less than 1% of our revenue is generated outside of the U.S.
Basis of Presentation
These unaudited condensed consolidated financial statements (Financial Statements) and accompanying notes have been prepared in accordance with accounting principles generally accepted in the United States of America (GAAP) for interim financial reporting and the instructions to Form 10-Q and Rule 10-01 of Regulation S-X of the Rules and Regulations of the Securities and Exchange Commission (SEC). Certain information and note disclosures included in our annual financial statements prepared in accordance with GAAP have been condensed or omitted pursuant to such rules and regulations. In the opinion of management, the condensed consolidated financial statements reflect all adjustments, that are normal and recurring in nature, necessary for fair financial statement presentation. The results of operations for the three and the nine months ended September 30, 2018 are not necessarily indicative of the operating results anticipated for the full year. These Financial Statements should be read in conjunction with the audited Consolidated Financial Statements included in Part II, Item 8 of our Annual Report on Form 10-K for the year ended December 31, 2017 (2017 Form 10-K).
Reclassifications
Certain prior year amounts have been reclassified to conform to current period presentation. These reclassifications include short-term restricted cash, cash equivalents and investments previously classified as WSE-related assets and now presented within restricted cash, cash equivalents and investments. Refer to the accounting policy below for a description of amounts currently included in restricted cash, cash equivalents, and investments.

FINANCIAL STATEMENTS

Use of Estimates

The preparation of financial statements in conformity with GAAP requires us to make estimates and assumptions that affect certain reported amounts and related disclosures. Significant estimates include:

- liability for unpaid losses and loss adjustment expenses (loss reserves) related to workers' compensation and workers' compensation collateral receivable,
- health insurance loss reserves,
- liability for insurance premiums payable,
- impairments of goodwill and other intangible assets,
- income tax assets and liabilities, and
- liability for legal contingencies.

These estimates are based on historical experience and on various other assumptions that we believe to be reasonable from the facts available to us. Some of the assumptions are highly uncertain at the time of estimation. To the extent actual experience differs from the assumptions used, our consolidated financial statements could be materially affected.

Revenue Recognition

On January 1, 2018, we adopted Accounting Standards Codification Topic 606 (ASC Topic 606) using the modified retrospective method applied to those contracts which were not completed as of January 1, 2018. Results for reporting periods beginning after January 1, 2018 are presented under ASC Topic 606, while the comparative prior period amounts are not restated and continue to be reported in accordance with statements previously accounted for under Accounting Standards Codification Topic 605.

Upon adoption of ASC Topic 606, we recorded a $1 million cumulative effect adjustment to opening retained earnings as of January 1, 2018. Impacts from adoption of the new standard on our revenue recognition include:

- Our annual service contracts with our clients that are cancellable with 30 days' notice are initially considered 30-day contracts under the new standard;
- Professional service revenues are recognized on an output basis which results in recognition at the time payroll is processed;
- Our non-refundable set up fees are no longer deferred but accounted for as part of our transaction price and are allocated among professional service revenues and insurance services revenues; and
- The majority of sales commissions related to onboarding new clients that were previously expensed are capitalized as contract assets and amortized over the estimated customer life.

Revenues are recognized when control of the promised services are transferred to our clients, in an amount that reflects the consideration that we expect to receive in exchange for services. We generate all of our revenue from contracts with customers. We disaggregate revenues into professional services revenues and insurance services revenues as reported on the condensed consolidated statements of operations and comprehensive income. Generally, both the client and the Company may terminate the contract without penalty by providing a 30-day notice.

FINANCIAL STATEMENTS

Performance Obligations

At contract inception, we assess the services promised in our contracts with customers and identify a performance obligation for each distinct promise to transfer to the customer a service or bundle of services. We determined that the following distinct services represent separate performance obligations:

- Payroll and payroll tax processing,
- Health benefits services, and
- Workers' compensation services.

Payroll and payroll tax processing performance obligations include services to process payroll and payroll tax-related transactions on behalf of our clients. Revenues associated with this performance obligation are reported as professional service revenues and recognized using an output method in which the control of the promised services is considered transferred when a client's payroll is processed by us and its WSEs are paid. Professional service revenues are stated net of the gross payroll and payroll tax amounts funded by our clients. Although we assume the responsibilities to process and remit the payroll and payroll related obligations, we do not assume employment-related responsibilities such as determining the amount of the payroll and related payroll obligations. As a result, we are the agent in this arrangement for revenue recognition purposes.

Health benefits and workers' compensation services include performance obligations to provide TriNet-sponsored health benefits and workers' compensation insurance coverage through insurance policies provided by third-party insurance carriers and settle high deductible amounts on those policies. Revenues associated with these performance obligations are reported as insurance services revenues and are recognized using the output method over the period of time that the client and WSEs are covered under TriNet-sponsored insurance policies.

We control the selection of health benefits and workers' compensation coverage made available, insurance services revenues are reported gross as we are the principal in this arrangement for revenue recognition purposes. See Item 8 Note 1 in our 2017 Form 10-K for further discussion on our accounting policy for insurance costs.

We generally charge new customers a nominal upfront non-refundable fee to recover our costs to set up the client on our TriNet platform for payroll processing and other administrative services, such as benefit enrollments. These fees are accounted for as part of our transaction price and are allocated among the performance obligations based on their relative standalone selling price.

Variable Consideration and Pricing Allocation

Our contracts with customers generally do not include any variable consideration. However, from time to time, we may offer incentive credits to our clients considered to be variable consideration including incentive credits issued related to contract renewals. Incentive credits are recorded as a reduction to revenue as part of the transaction price at contract inception when there is a basis to reasonably estimate the amount of the incentive credit and only to the extent that it is probable that a significant reversal of any incremental revenue will not occur. These incentive credits are allocated among the performance obligations based on their relative standalone selling price.

We allocate the total transaction price to each performance obligation based on the estimated relative standalone selling prices of the promised services underlying each performance obligation. The transaction price for payroll and payroll tax processing performance obligations are determined upon establishment of the contract that contains the final terms of the sale, including the description and price of each service purchased. The estimated service fee is calculated based on observable inputs and include the following key assumptions: target profit margin, pricing strategies including the mix of services purchased and competitive factors, and customer and industry specifics.

The transaction price for health benefits insurance and worker's compensation insurance performance obligations is determined during the new client on-boarding and enrollment processes based on the types of benefits coverage the clients and WSEs have elected and the applicable risk profile of the client. We estimate our service fees based on actuarial forecasts of our expected insurance premiums and claim costs, and to amounts to cover our costs to administer these programs.

We require our clients to prefund payroll and related taxes and other withholding liabilities before payroll is processed or due for payment. Under the provision of our contracts with customers, we generally will process the payment of a client's payroll only when the client successfully funds the amount required. As a result, there is no financing arrangement