Performant Financial Corp
Form 10-Q
November 13, 2017
Table of Contents

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 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, 2017
or
¨ TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from to
Commission File Number: 001-35628

PERFORMANT FINANCIAL CORPORATION
(Exact name of registrant as specified in its charter)

Delaware	20-0484934
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

Performant Financial Corporation
333 North Canyons Parkway
Livermore, CA 94551
(925) 960-4800
(Address, including zip code and telephone number, including area code of registrant's principal executive offices)

Indicate by check mark whether the registrant (1) has filed all reports required 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 ¨
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 ¨
Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company. See the definitions of "large accelerated filer", "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act). (Check one):
Large accelerated filer ¨ Accelerated filer ¨

Non-accelerated filer ¨ Smaller reporting company x

Indicate by check mark whether the registrant is an emerging growth company as defined in Rule 405 of the Securities Act of 1933 (§ 230.405 of this chapter) or Rule 12b-2 of the Securities Exchange Act of 1934 (§ 240.12b-2 of this chapter).
x Emerging growth company

Table of Contents

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.
Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes ¨ No x
The number of shares of Common Stock outstanding as of November 13, 2017 was 50,961,377.

Table of Contents

PERFORMANT FINANCIAL CORPORATION
QUARTERLY REPORT ON FORM 10-Q
FOR THE QUARTER ENDED SEPTEMBER 30, 2017
INDEX

Table of Contents

PERFORMANT FINANCIAL CORPORATION AND SUBSIDIARIES
Consolidated Balance Sheets
(In thousands)

	September 30, 2017 (Unaudited)	December 31, 2016
Assets		
Current assets:		
Cash and cash equivalents	$ 23,179	$ 32,982
Restricted cash	—	7,502
Trade accounts receivable, net of allowance for doubtful accounts of $0 and $224, respectively	12,490	11,484
Deferred income taxes	—	5,331
Prepaid expenses and other current assets	14,222	12,686
Income tax receivable	1,454	2,027
Total current assets	51,345	72,012
Property, equipment, and leasehold improvements, net	21,393	23,735
Identifiable intangible assets, net	5,066	5,895
Goodwill	81,572	82,522
Deferred income taxes	3,534	—
Other assets	897	914
Total assets	$ 163,807	$ 185,078
Liabilities and Stockholders’ Equity		
Current liabilities:		
Current maturities of notes payable, net of unamortized debt issuance costs of $138 and $1,294, respectively	$ 1,512	$ 9,738
Accrued salaries and benefits	5,640	4,315
Accounts payable	1,052	628
Other current liabilities	3,860	4,409
Estimated liability for appeals	19,145	19,305
Net payable to client	12,669	13,074
Total current liabilities	43,878	51,469
Notes payable, net of current portion and unamortized debt issuance costs of $3,549 and $272, respectively	38,801	43,878
Deferred income taxes	—	1,130
Other liabilities	2,099	2,356
Total liabilities	84,778	98,833
Commitments and contingencies		
Stockholders’ equity:		
Common stock, $0.0001 par value. Authorized, 500,000 shares at September 30, 2017 and December 31, 2016; issued and outstanding 50,949 and 50,234 shares at September 30, 2017 and December 31, 2016, respectively	5	5
Additional paid-in capital	71,684	65,650
Retained earnings	7,340	20,590
Total stockholders’ equity	79,029	86,245

Total liabilities and stockholders' equity	$ 163,807	$ 185,078

See accompanying notes to consolidated financial statements.

1

Table of Contents
PERFORMANT FINANCIAL CORPORATION AND SUBSIDIARIES
Consolidated Statements of Operations
(In thousands, except per share amounts)
(Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2017	2016	2017	2016
Revenues	$29,744	$31,195	$98,760	$107,548
Operating expenses:				
Salaries and benefits	20,494	18,710	61,640	60,107
Other operating expenses	13,496	12,311	43,019	40,401
Total operating expenses	33,990	31,021	104,659	100,508
Income (loss) from operations	(4,246)	174	(5,899)	7,040
Interest expense	(2,459)	(1,863)	(5,683)	(6,136)
Income (loss) before provision for (benefit from) income taxes	(6,705)	(1,689)	(11,582)	904
Provision for (benefit from) income taxes	1,146	(974)	1,668	62
Net income (loss)	$(7,851)	$(715)	$(13,250)	$842
Net income (loss) per share				
Basic	$(0.15)	$(0.01)	$(0.26)	$0.02
Diluted	$(0.15)	$(0.01)	$(0.26)	$0.02
Weighted average shares				
Basic	50,852	50,200	50,581	49,974
Diluted	50,852	50,200	50,581	50,401

See accompanying notes to consolidated financial statements.

2

Table of Contents

PERFORMANT FINANCIAL CORPORATION AND SUBSIDIARIES
Consolidated Statements of Comprehensive Income (Loss)
(In thousands)
(Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2017	2016	2017	2016
Net income (loss)	$(7,851)	$(715)	$(13,250)	$842
Other comprehensive income:				
Foreign currency translation adjustment	1	(1)	(4)	24
Comprehensive income (loss)	$(7,850)	$(716)	$(13,254)	$866

See accompanying notes to consolidated financial statements.

Table of Contents

PERFORMANT FINANCIAL CORPORATION AND SUBSIDIARIES
Consolidated Statements of Cash Flows
(In thousands)
(Unaudited)

	Nine Months Ended September 30, 2017	2016
Cash flows from operating activities:		
Net income (loss)	$(13,250)	$842
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Loss on disposal of assets	67	12
Impairment of goodwill and intangible assets	1,081	—
Depreciation and amortization	8,381	10,098
Deferred income taxes	667	(2,455)
Stock-based compensation	3,027	3,546
Interest expense from debt issuance costs	989	874
Write-off unamortized debt issuance costs	1,049	468
Interest expense paid in kind	331	—
Changes in operating assets and liabilities:		
Trade accounts receivable	(1,006)	7,656
Prepaid expenses and other current assets	(1,536)	55
Income tax receivable	573	(658)
Other assets	17	22
Accrued salaries and benefits	1,325	3,757
Accounts payable	424	152
Other current liabilities	(547)	(2,210)
Income taxes payable	—	(895)
Estimated liability for appeals	(160)	438
Net payable to client	(405)	(981)
Other liabilities	(257)	(230)
Net cash provided by operating activities	770	20,491
Cash flows from investing activities:		
Purchase of property, equipment, and leasehold improvements	(5,408)	(5,529)
Net cash used in investing activities	(5,408)	(5,529)
Cash flows from financing activities:		
Repayment of notes payable	(55,513)	(29,307)
Restricted cash for repayment of notes payable	7,502	(7,507)
Debt issuance costs paid	(858)	(800)
Taxes paid related to net share settlement of stock awards	(382)	(261)
Proceeds from exercise of stock options	90	333
Borrowings from notes payable	44,000	—
Income tax benefit from employee stock options	—	103
Payment of purchase obligation	—	(427)
Net cash used in financing activities	(5,161)	(37,866)
Effect of foreign currency exchange rate changes on cash	(4)	24
Net decrease in cash and cash equivalents	(9,803)	(22,880)
Cash and cash equivalents at beginning of period	32,982	71,182
Cash and cash equivalents at end of period	$23,179	$48,302

Non-cash financing activities:		
Recognition of warrant issued in debt financing	$3,302	$—
Supplemental disclosures of cash flow information:		

4

Table of Contents
PERFORMANT FINANCIAL CORPORATION AND SUBSIDIARIES
Consolidated Statements of Cash Flows
(In thousands)
(Unaudited)

Cash paid for income taxes	$540	$3,976
Cash paid for interest	$2,835	$4,797

See accompanying notes to consolidated financial statements.

Table of Contents
PERFORMANT FINANCIAL CORPORATION AND SUBSIDIARIES
Notes To Consolidated Financial Statements
For the Three and Nine Months Ended September 30, 2017 and 2016
(Unaudited)

1. Organization and Description of Business
(a) Basis of Presentation and Organization
The accompanying unaudited consolidated financial statements have been prepared in accordance with U.S. Generally Accepted Accounting Principles, or U.S. GAAP, for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and notes required by U.S. GAAP for complete financial statements. In the opinion of management, the unaudited interim financial statements furnished herein include all adjustments necessary (consisting only of normal recurring adjustments) for a fair presentation of our and our subsidiaries' financial position at September 30, 2017, the results of our operations for the three and nine months ended September 30, 2017 and 2016 and cash flows for the nine months ended September 30, 2017 and 2016. Interim financial statements are prepared on a basis consistent with our annual consolidated financial statements. The interim financial statements included herein should be read in conjunction with the consolidated financial statements and related notes included in our annual report on Form 10-K for the years ended December 31, 2016, 2015, and 2014.
The Company is a leading provider of technology-enabled audit, recovery, and analytics services in the United States. The Company's services help identify improper payments, and in some markets, restructure and recover delinquent or defaulted assets and improper payments for both government and private clients across different markets. The Company's clients typically operate in complex and regulated environments and outsource their recovery needs in order to reduce losses on billions of dollars of defaulted student loans, improper healthcare payments and delinquent state tax and federal treasury receivables. The Company generally provides services on an outsourced basis, where we handle many or all aspects of the clients' various processes.
The Company's consolidated financial statements include the operations of Performant Financial Corporation (PFC), its wholly owned subsidiary Performant Business Services, Inc., and its wholly owned subsidiaries Performant Recovery, Inc. (Recovery), Performant Technologies, Inc., and Performant Europe Ltd. PFC is a Delaware corporation headquartered in California and was formed in 2003. Performant Business Services, Inc. is a Nevada corporation founded in 1997. Recovery is a California corporation founded in 1976. Performant Technologies, Inc. is a California corporation that was formed in 2004. All significant intercompany balances and transactions have been eliminated in consolidation.
The Company is managed and operated as one business, with a single management team that reports to the Chief Executive Officer.
The preparation of the consolidated financial statements in conformity with U.S. GAAP, requires management to make certain estimates and assumptions that affect the reported amounts of assets and liabilities, primarily accounts receivable, intangible assets, goodwill, estimated liability for appeals, accrued expenses, 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 periods. Our actual results could differ from those estimates.
(b) Revenues, Accounts Receivable, and Estimated Liability for Appeals
Revenue is recognized upon the collection of defaulted loan and debt payments. Loan rehabilitation revenue is recognized when the rehabilitated loans are sold (funded) by clients. Incentive revenue is recognized upon receipt of official notification of incentive award from customers. Under the Company's Medicare Recovery Audit Contractor, or RAC, contract with Centers for Medicare and Medicaid Services, or CMS, the Company recognizes revenues when the healthcare provider has paid CMS for a given claim or has agreed to an offset against other claims by the provider. Providers have the right to appeal a claim and may pursue additional appeals if the initial appeal is found in favor of CMS. The Company accrues an estimated liability for appeals at the time revenue is recognized based on the Company's estimate of the amount of revenue probable of being refunded to CMS following successful appeal. In

addition, if the Company's estimate of the liability for appeals with respect to revenues recognized during a prior period changes, the Company increases or decreases current period accruals based on such change in estimated liability. At September 30, 2017, a total of $18.8 million was presented as an allowance against revenue, representing the Company's estimate of claims audited under the CMS contract that may be overturned. Of this, none was related to accounts receivable and $18.8 million was related to commissions which had already been received. In addition to the $18.8 million related to the RAC contract with CMS, the Company has accrued $0.3 million of additional estimated liability for appeals related to other healthcare contracts. The total accrued liability for appeals of $19.1 million has been presented in the caption estimated liability for appeals at September 30, 2017. At December 31, 2016, the total appeals-related liability was $19.3 million. The $19.1 million balance at September 30, 2017 and $19.3 million at December 31, 2016, represent the Company's best estimate of the probable amount of losses related to appeals of claims for which commissions were previously collected. In addition to the $19.1 million amount accrued at September 30, 2017, the Company estimates that it is reasonably possible that it could be required to pay an additional amount up to approximately $5.4 million as a result of potentially successful appeals. To the extent that required payments by the Company exceed the amount accrued, revenues in the applicable period would be reduced by the amount of the excess. The zero allowance against accounts receivable at September 30, 2017 resulted from no customer receivables existing in an aged position which required a specific reserve; while the allowance at December 31, 2016 was $0.2 million.

(c) Net Payable to Client

The Company nets outstanding accounts receivable invoices from an audit and recovery contract against payables for overturned audits. The overturned audits are netted against current fees due on the invoice to the client when they are processed by the client's system. The "Net payable to client" balance of $12.7 million and $13.1 million at September 30, 2017 and December 31, 2016, respectively, represent the excess of payables for overturned audits. The Company expects that the net payable to client balance will be paid to the client within the next twelve months.

(d) Prepaid Expenses and Other Current Assets

At September 30, 2017, prepaid expenses and other current assets includes $5.6 million of amounts estimated to become due from subcontractors. The Company employs subcontractors to audit claims as part of an audit & recovery contract, and to the extent that audits by these subcontractors are overturned on appeal, the fees associated with such claims are contractually refundable to the Company. At September 30, 2017, the receivable associated with estimated future overturns of subcontractor audits was $5.6 million. In addition, at September 30, 2017, prepaid expenses and other current assets includes a net receivable of $3.7 million for subcontractor fees for already overturned audits refundable to the Company once the Company refunds its fees to the client as prime contractor. By comparison, at December 31, 2016, prepaid expenses and other current assets included $5.7 million of estimated future overturns of subcontractor audits, as well as a net receivable of $3.7 million for subcontractor fees for already overturned audits refundable to the Company once the Company refunds its fees to the client as prime contractor.

(e) Impairment of Goodwill and Long-Lived Assets

Goodwill and long-lived assets are evaluated for impairment whenever events or changes in circumstances indicate that the carrying amount of such assets or intangibles may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of the assets to future undiscounted net cash flows expected to be generated by the assets. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds the fair value of the assets. For the nine months ended September 30, 2017, an impairment expense of $1.1 million was recognized to account for the write-off of goodwill and intangible assets in one of our subsidiaries, Performant Europe Ltd., due to the Company's decision to wind down activity in this business. The expense has been included in other operating expenses in the consolidated statements of operations. There was no impairment expense for goodwill and long-lived assets for the nine months ended September 30, 2016.

(f) Restricted Cash

On August 3, 2017, $6.0 million of restricted cash was paid to the administrative agent for the benefit of the lenders under our Prior Credit Agreement. At September 30, 2017, and at December 31, 2016, restricted cash included in current assets on our consolidated balance sheet was $0.0 million and $7.5 million, respectively.

(g) New Accounting Pronouncements

Recently Adopted Accounting Standards

In November 2015, the FASB issued Accounting Standards Update (ASU) 2015-17, "Income Taxes (Topic 740): Balance Sheet Classification of Deferred Taxes" ("ASU 2015-17"), which simplifies the reporting requirements of deferred taxes by requiring all organizations to classify all deferred tax assets and liabilities, along with any related valuation allowance, as noncurrent. The guidance is effective for public companies with annual reporting periods beginning after December 15, 2016, including interim periods within that reporting period. We adopted ASU-2015-17 during our first quarter of 2017 on a prospective basis.

Table of Contents

During the first quarter 2017, the Company adopted ASU 2016-09, "Improvements to Employee Share-Based Payment Accounting" (ASU 2016-09) on a prospective basis. As a result of the adoption, the Company recognized $84 thousand of income tax expense for the nine months ended September 30, 2017. These tax benefits, or shortfalls, were historically recorded in equity. In addition, cash flows related to excess tax benefits, or shortfalls, are now classified as an operating activity. Cash paid on employees' behalf related to shares withheld for tax purposes is classified as a financing activity, consistent with prior year's presentation.

Recently Issued Accounting Standards

In May 2014, the FASB issued an ASU that amends the FASB ASC by creating a new Topic 606, "Revenue from Contracts with Customers". The new guidance will supersede the revenue recognition requirements in Topic 605, "Revenue Recognition", and most industry-specific guidance on revenue recognition throughout the Industry Topics of the Codification. The core principle of the guidance is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. To achieve that core principle, an entity should apply a five step model for recognizing and measuring revenue from contracts with customers. In addition, an entity should disclose sufficient qualitative and quantitative information to enable users of financial statements to understand the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers. The new revenue recognition guidance, including subsequent amendments, is effective for annual reporting periods beginning after December 15, 2017, including interim periods within that reporting period, with the option to early adopt the standard for annual periods beginning after December 15, 2016. We have not adopted this guidance early and are currently evaluating the effect on our consolidated financial statements.

In February 2016, the FASB issued ASU 2016-02, "Leases", which, for operating leases, requires a lessee to recognize a right-of-use asset and a lease liability, initially measured at the present value of the lease payments, in its balance sheet. The standard also requires a lessee to recognize a single lease cost, calculated so that the cost of the lease is allocated over the lease term, on a generally straight-line basis. This new guidance is effective for annual reporting periods beginning after December 15, 2018 with early adoption permitted. We have not adopted this guidance early and are currently evaluating the effect on our consolidated financial statements.

In August 2016, the FASB issued ASU 2016-15, "Statement of Cash Flows: Classification of Certain Cash Receipts and Cash Payments" which provides guidance on the presentation of certain cash receipts and cash payments in the statement of cash flows in order to reduce diversity in existing practice. This new guidance is effective for annual reporting periods, and interim periods within those years, beginning after December 15, 2017, and early adoption is permitted. This new standard requires retrospective adoption, with a provision for impracticability. We have not adopted this guidance early and are currently evaluating the effect on our consolidated financial statements.

In January 2017, the FASB issued ASU 2017-04, "Simplifying the Test for Goodwill Impairment" to simplify the goodwill impairment testing process. The new standard eliminates Step 2 of the goodwill impairment test. If a company determines in Step 1 of the goodwill impairment test that the carrying value of goodwill is less than the fair value, an impairment in that amount should be recorded to the income statement, rather than proceeding to Step 2. This new guidance is effective for annual reporting periods, and interim periods with goodwill impairment tests within those years, beginning after December 15, 2019, and early adoption is permitted for testing periods after January 1, 2017. We have not adopted this guidance early and are currently evaluating the effect on our consolidated financial statements.

Table of Contents

2. Property, Equipment, and Leasehold Improvements

Property, equipment, and leasehold improvements consist of the following at September 30, 2017 and December 31, 2016 (in thousands):

	September 30, 2017	December 31, 2016
Land	$ 1,122	$ 1,122
Building and leasehold improvements	6,223	6,203
Furniture and equipment	5,706	5,656
Computer hardware and software	70,615	67,861
	83,666	80,842
Less accumulated depreciation and amortization	(62,273)	(57,107)
Property, equipment and leasehold improvements, net	$ 21,393	$ 23,735

Depreciation expense of property, equipment and leasehold improvements was $2.5 million and $2.4 million for the three months ended September 30, 2017 and 2016, respectively, $7.7 million and $7.3 million for the nine months ended September 30, 2017 and 2016, respectively.

3. Credit Agreement

On March 19, 2012, we, through our wholly owned subsidiary, entered into a $147.5 million credit agreement, as amended and restated, with Madison Capital Funding LLC as administrative agent, ING Capital LLC as syndication agent, and other lenders party thereto (as amended, the "Prior Credit Agreement"). The senior credit facility consists of (i) a $57.0 million Term A loan that matured and was fully paid in March 2017, (ii) a $79.5 million Term B loan that matures in June 2018, and (iii) a $11.0 million revolving credit facility that expired and was fully paid in March 2017. On June 28, 2012, we amended the Credit Agreement to increase the amount of our borrowings under our Term B loan by $19.5 million.

On November 4, 2014, February 19, 2016, July 26, 2016, October 27, 2016, and March 22, 2017, the Prior Credit Agreement was further amended to, among other things, modify a number of existing covenants and add new covenants requiring the Company to maintain a minimum cash balance, comply with an interest coverage ratio and achieve minimum EBITDA levels. On May 3, 2017, we further amended the credit agreement (the "Eighth Amendment") to extend the maturity date of the Term B loan to June 19, 2018. As a result of this extension, regularly scheduled quarterly amortization payments of $247,500 were also extended through March 31, 2018, with the remaining outstanding principal amount due on the June 19, 2018 maturity date. Interest on the Term B loan charged under the credit agreement was also increased by 3.00% per annum, however the amount of such increased interest was payable in kind. Pursuant to the Eighth Amendment, the quarterly and annual financial reporting covenants were also modified to require that the Company’s financial statements not contain a qualification, if required by GAAP, with respect to our ability to continue as a going concern.

On August 7, 2017, we, through our wholly-owned subsidiary Performant Business Services, Inc. (the "Borrower"), entered into a new credit agreement with ECMC Group, Inc. (the “New Credit Agreement”). The New Credit Agreement provides for a term loan facility in the initial amount of $44 million (the “Initial Term Loan”) and for up to $15 million of additional term loans (“Additional Term Loans”; and together with the Initial Term Loan, the “Loans”) which Additional Term Loans may be drawn until the second anniversary of the funding of the Initial Term Loans, subject to the satisfaction of customary conditions. On August 11, 2017, the Initial Term Loan was advanced (the "Closing Date") and the proceeds were applied to repay all outstanding amounts under the Prior Credit Agreement. On September 29, 2017, we entered into Amendment No. 1 to the New Credit Agreement to extend the initial interest payment due date to December 31, 2017. Approximately $2 million of contingent reimbursement obligations with respect to outstanding but undrawn letters of credit remain outstanding under the Prior Credit Agreement, however, those contingent reimbursement obligations will remain cash collateralized with the administrative agent.

The Loans will mature on the third anniversary of the Closing Date, however we will have the option to extend the maturity of the Loans for two additional one year periods, subject to the satisfaction of customary conditions. The Loans will bear interest at the one-month LIBOR rate (subject to a 1% per annum floor) plus a margin which may vary from 5.5% per annum to 10.0% per annum based on our total debt to EBITDA ratio. The Initial Term Loans will initially bear interest at LIBOR plus 7.0% per annum. We will be required to pay 5% of the original principal balance of the Loans annually in quarterly installments beginning March 31, 2018, and to offer to make mandatory prepayments of the Loans with a percentage of our excess cash flow which may vary between 75% and 0% depending on our total debt to EBITDA ratio. In addition to mandatory

Table of Contents

prepayments for excess cash flow, we will also be required to offer to prepay the Loans with the net cash proceeds of certain asset dispositions and with the issuance of debt not otherwise permitted under the New Credit Agreement. Except in connection with a change of control and the payment of a 1% premium, we will not be permitted to voluntarily prepay the Loans until after the first anniversary of the Closing Date. We will be permitted to prepay the Loans during the second year after the Closing Date if accompanied by a prepayment premium of 1%. Thereafter, we will be permitted to prepay the Loans without any prepayment premium.

The New Credit Agreement contains certain restrictive financial covenants which became effective on the Closing Date. Such covenants require, among other things, that we meet a minimum fixed charge coverage ratio of 0.5 to 1.0 through December 31, 2019, 1.0 to 1.0 through June 30, 2020 (or until December 31, 2020 if the maturity date of the Loans is extended until the fourth anniversary of the Closing Date), 1.25 to 1.0 through June 30, 2021 if the maturity date of the Loans is extended until the fourth anniversary of the Closing Date and 1.25 to 1.0 through June 30, 2022 if the maturity date of the Loans is extended until the fifth anniversary of the Closing Date. In addition, we will be required to maintain, a maximum total debt to EBITDA ratio of 6.00 to 1.00. The New Credit Agreement also contains covenants that will restrict the Company and its subsidiaries' ability to incur certain types or amounts of indebtedness, incur liens on certain assets, make material changes in corporate structure or the nature of its business, dispose of material assets, engage in a change in control transaction, make certain foreign investments, enter into certain restrictive agreements, or engage in certain transactions with affiliates.

The obligations under the New Credit Agreement are secured by substantially all of our United States domestic subsidiaries' assets and are guaranteed by the Company and its United States domestic subsidiaries, other than the Borrower.

As a result of our entry into our New Credit Agreement, and the repayment of all amounts owed under the Prior Credit Agreement, we wrote off debt issuance costs related to the Prior Credit Agreement of approximately $1.0 million in August 2017.

Scheduled payments under the Agreement for the next five years and thereafter are as follows (in thousands):

Year Ending December 31,	Amount
Remainder of 2017	$—
2018	2,200
2019	2,200
2020	39,600
2021	—
Thereafter	—
Total	$44,000

In consideration for, and concurrently with, the extension of the Initial Term Loan in accordance with the terms of the New Credit Agreement, we issued a warrant to the lender to purchase up to an aggregate of 3,863,326 shares of the Company's common stock (representing approximately up to 7.5% of our diluted common stock as calculated using the "treasury stock" method as defined under GAAP for the most recent fiscal quarter) with an exercise price of $1.92 per share. Upon our election to borrow any of the Additional Term Loans, we will be required to issue additional warrants at the same exercise price to purchase up to an aggregate of 77,267 additional shares of common stock (which represents approximately 0.15% of our diluted common stock calculated using the "treasury stock" method as defined under GAAP for the most recent fiscal quarter) for each $1,000,000 of such Additional Term Loans.

The Company has accounted for this warrant as an equity instrument since the Warrant is indexed to the Company's common shares and meets the criteria for classification in shareholders' equity. The relative fair value of the Warrant on the date of issuance was approximately $3.3 million and is treated as a discount to the debt. This amount will be amortized to interest expense under the effective interest method over the life of the Term Loan, which is a period of 36 months. The Company estimated the value of the Warrant using the Black-Scholes model. The key assumptions used to value the Warrant are as follows:

Table of Contents

Exercise price	$1.92
Share price on date of issuance	$1.85
Volatility	50.0 %
Risk-free interest rate	1.83 %
Expected dividend yield	— %
Contractual term (in years)	5

In addition, at the closing of the Term Loan, the Company paid transaction costs of $0.6 million, which were recorded as a discount on the debt and will be amortized to interest expense using the effective interest method over the life of the initial Term Loan, which is a period of 36 months.

Outstanding debt obligations are as follows (in thousands):

	September 30, 2017
Principal amount	$ 44,000
Less: unamortized discount and debt issuance costs	(3,687)
Loan payable less unamortized discount and debt issuance costs	40,313
Less: current maturities	(1,512)
Long-term loan payable, net of current maturities	$ 38,801

4. Commitments and Contingencies

We have entered into various non-cancelable operating lease agreements for certain of our office facilities and equipment with original lease periods expiring between 2017 and 2022. Certain of these arrangements have free rent periods and /or escalating rent payment provisions, and we recognize rent expense under such arrangements on a straight-line basis. In October 2017, we renewed our lease agreements for office space for approximately 50,000 square feet in Livermore, California.

Future minimum rental commitments under non-cancelable leases as of September 30, 2017 are as follows (in thousands):

Year Ending December 31,	Amount
Remainder of 2017	$ 393
2018	2,223
2019	2,158
2020	2,109
2021	1,377
Thereafter	933
Total	$ 9,193

Operating lease expense was $0.6 million and $0.7 million for the three months ended September 30, 2017 and 2016, respectively, and was $2.0 million and $2.1 million for the nine months ended September 30, 2017 and 2016, respectively.

5. Stock-based Compensation

(a) Stock Options

Total stock-based compensation expense charged as salaries and benefits expense in the consolidated statements of operations was $0.7 million and $1.2 million for the three months ended September 30, 2017 and 2016, respectively, and $3.0 million and $3.5 million for the nine months ended September 30, 2017 and 2016, respectively.

Table of Contents

The following table shows stock option activity for the nine months ended September 30, 2017:

	Outstanding Options	Weighted average exercise price per share	Weighted average remaining contractual life (Years)	Aggregate Intrinsic Value (in thousands)
Outstanding at December 31, 2016	3,506,529	$ 7.32	5.04	$ 1,367
Granted	—	—		
Forfeited	(159,310)	5.38		
Exercised	(188,959)	0.50		
Outstanding at September 30, 2017	3,158,260	$ 7.83	4.41	$ 613
Vested, exercisable, expected to vest(1) at September 30, 2017	3,149,795	$ 7.83	4.41	$ 613
Exercisable at September 30, 2017	2,980,079	$ 7.98	4.24	$ 610

(1) Options expected to vest reflect an estimated forfeiture rate.

The Company recognizes share-based compensation costs as expense on a straight-line basis over the option vesting period, which generally is four to five years.

(b) Restricted Stock Units and Performance Stock Units

The following table summarizes restricted stock unit and performance stock unit activity for the nine months ended September 30, 2017:

	Number of Awards	Weighted average grant date fair value per share
Outstanding at December 31, 2016	2,060,240	$ 2.70
Granted	1,481,252	2.41
Forfeited	(371,800)	2.98
Expired	(40,500)	2.57
Vested and converted to shares, net of units withheld for taxes	(533,872)	2.73
Units withheld for taxes	(209,743)	2.73
Outstanding at September 30, 2017	2,385,577	$ 2.46
Expected to vest at September 30, 2017	2,266,348	$ 2.46

Restricted stock units and performance stock units granted under the Performant Financial Corporation 2012 Stock Incentive Plan generally vest over periods ranging from one to four years.

6. Income Taxes

Our effective income tax rate changed to a negative rate of (14.4)% for the nine months ended September 30, 2017 from 6.9% for the nine months ended September 30, 2016. The decrease in the effective tax rate is primarily due to more significant losses from operations generated in the nine months ended September 30, 2017 for which no tax benefit is recognized compared to the income tax expense recorded on income from operations for the nine months ended September 30, 2016.

We file income tax returns with the U.S. federal government and various state jurisdictions. We operate in a number of state and local jurisdictions, most of which have never audited our records. Accordingly, we are subject to state and local income tax examinations based upon the various statutes of limitations in each jurisdiction. For tax years before 2014, the Company is no longer subject to Federal and certain other state tax examinations. We are currently being examined by the Franchise Tax Board of California for tax years 2011 through 2014.

Table of Contents

7. Earnings per Share

For the three and nine months ended September 30, 2017 and 2016, basic income per share is calculated by dividing net income by the sum of the weighted average number of shares of Common Stock outstanding during the period. Diluted income per share is calculated by dividing net income by the weighted average number of shares of Common Stock and dilutive common share equivalents outstanding during the period. Common share equivalents consist of stock options, restricted stock units, and performance stock units. When there is a loss in the period, dilutive common share equivalents are excluded from the calculation of diluted earnings per share, as their effect would be anti-dilutive. For example, for the three months and nine months ended September 30, 2017, and the three months ended September 30, 2016, dilutive common share equivalents have been excluded, and diluted weighted average shares outstanding are the same as basic average shares outstanding. When there is net income in the period, the Company excludes stock options, restricted stock units, and performance stock units from the calculation of diluted earnings per share when the combined exercise price, unamortized fair value and excess tax benefits of the options exceed the average market price of the Company's common stock because their effect would be anti-dilutive. For the nine months ended September 30, 2016, the Company excluded 4,559,511 options from the calculation of diluted earnings per share because their effect would be anti-dilutive.

The following table reconciles the basic to diluted weighted average shares outstanding using the treasury stock method (shares in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2017	2016	2017	2016
Weighted average shares outstanding – basic	50,852	50,200	50,581	49,974
Dilutive effect of stock options	—	—	—	427
Weighted average shares outstanding – diluted	50,852	50,200	50,581	50,401

8. Subsequent Events

We have evaluated subsequent events through the date these consolidated financial statements were issued and there are no other events that have occurred that would require adjustments or disclosures to our consolidated financial statements.

Table of Contents

ITEM 2. MANAGEMENT’S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS.

You should read the following discussion in conjunction with our condensed consolidated financial statements (unaudited) and related notes included elsewhere in this report. This report on Form 10-Q contains forward-looking statements that involve risks and uncertainties. The words “believe,” “may,” “will,” “estimate,” “continue,” “anticipate,” “desig “intend,” “expect” and similar expressions are intended to identify forward-looking statements. We have based these forward-looking statements largely on our current expectations and projections about future events and trends that we believe may affect our financial condition, results of operations, strategy, short-term and long-term business operations and objectives, and financial needs. These forward-looking statements are subject to a number of risks, uncertainties and assumptions, including those described in “Risk Factors” under Item 1A of Part II of this report. In light of these risks, uncertainties and assumptions, the forward-looking events and trends discussed in this report may not occur, and actual results could differ materially and adversely from those anticipated or implied in the forward-looking statements. Forward-looking statements include, but are not limited to, statements about our: opportunities and expectations for growth in the student lending, healthcare and other markets; anticipated trends and challenges in our business and competition in the markets in which we operate; our client relationships and our ability to maintain such client relationships; our ability to maintain compliance with the covenants in our debt agreements; the adaptability of our technology platform to new markets and processes; our ability to invest in and utilize our data and analytics capabilities to expand our capabilities; the sufficiency of our appeals reserve; our growth strategy of expanding in our existing markets and considering strategic alliances or acquisitions; our ability to meet our liquidity and worki