

Q2 Holdings, Inc.
Form 10-Q
November 03, 2016
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

(Mark One),

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

For the quarterly period ended September 30, 2016.

or

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

For the transition period from to

Q2 Holdings, Inc.

(Exact name of Registrant as Specified in Its Charter)

Delaware

(State or Other Jurisdiction of
Incorporation or Organization)

001-36350

(Commission File Number)

20-2706637

(IRS Employer

Identification No.)

13785 Research Blvd., Suite 150

Austin, Texas 78750

(512) 275-0072

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

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

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

Large accelerated filer Accelerated filer Non-accelerated filer Smaller reporting company
(do not check if a
smaller reporting company)

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date: 40,138,663 shares of Common Stock, \$0.0001 par value per share as of October 31, 2016.

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PART I - FINANCIAL INFORMATION

Item 1. Financial Statements.

Q2 HOLDINGS, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS

(in thousands, except per share data)

	September 30, 2016 (unaudited)	December 31, 2015
Assets		
Current assets:		
Cash and cash equivalents	\$ 51,623	\$ 67,049
Restricted cash	2,159	2,123
Investments	40,708	43,571
Accounts receivable, net	16,246	9,009
Prepaid expenses and other current assets	5,335	3,058
Deferred solution and other costs, current portion	8,304	5,968
Deferred implementation costs, current portion	3,038	2,440
Total current assets	127,413	133,218
Property and equipment, net	28,994	24,440
Deferred solution and other costs, net of current portion	12,106	10,146
Deferred implementation costs, net of current portion	7,622	6,045
Intangible assets, net	15,631	17,192
Goodwill	12,876	12,876
Other long-term assets	642	551
Total assets	\$ 205,284	\$ 204,468
Liabilities and stockholders' equity		
Current liabilities:		
Accounts payable	\$ 5,082	\$ 3,450
Accrued liabilities	9,069	11,319
Accrued compensation	14,037	7,712
Deferred revenues, current portion	32,290	23,051
Capital lease obligations, current portion	—	161
Total current liabilities	60,478	45,693
Deferred revenues, net of current portion	32,266	29,188
Deferred rent, net of current portion	9,750	7,359
Other long-term liabilities	292	4,254
Total liabilities	102,786	86,494
Commitments and contingencies (Note 8)		
Stockholders' equity:		
Preferred stock: \$0.0001 par value; 5,000 shares authorized; no shares issued or outstanding as of September 30, 2016 and December 31, 2015	—	—
Common stock: \$0.0001 par value; 150,000 shares authorized; 40,125 issued and 40,114 shares outstanding as of September 30, 2016 and 38,891 shares issued and 38,889 shares outstanding as of December 31, 2015	4	4
Treasury stock at cost: 11 shares at September 30, 2016 and 2 shares at December 31, 2015	(264) (41
Additional paid-in capital	221,041	207,541
Accumulated other comprehensive loss	(13) (101
Accumulated deficit	(118,270) (89,429

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Total stockholders' equity	102,498	117,974
Total liabilities and stockholders' equity	\$ 205,284	\$ 204,468

The accompanying notes are an integral part of these condensed consolidated financial statements.

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Q2 HOLDINGS, INC.

CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE LOSS

(unaudited)

(in thousands, except per share data)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
Revenues	\$38,305	\$28,018	\$108,069	\$78,459
Cost of revenues ⁽¹⁾	19,599	15,135	56,283	42,545
Gross profit	18,706	12,883	51,786	35,914
Operating expenses:				
Sales and marketing ⁽¹⁾	8,980	6,660	26,798	19,841
Research and development ⁽¹⁾	8,219	5,979	23,952	14,927
General and administrative ⁽¹⁾	8,624	5,961	23,482	16,430
Acquisition related costs	1,835	1,006	4,793	1,006
Amortization of acquired intangibles	368	227	1,104	227
Unoccupied lease charges	—	—	33	—
Total operating expenses	28,026	19,833	80,162	52,431
Loss from operations	(9,320)	(6,950)	(28,376)	(16,517)
Other income (expense):				
Interest and other income	90	84	260	205
Interest and other expense	(154)	(71)	(395)	(208)
Total other income (expense), net	(64)	13	(135)	(3)
Loss before income taxes	(9,384)	(6,937)	(28,511)	(16,520)
Provision for income taxes	(97)	(79)	(330)	(123)
Net loss	\$(9,481)	\$(7,016)	\$(28,841)	\$(16,643)
Other comprehensive loss:				
Unrealized (loss) gain on available-for-sale investments	(17)	25	88	(11)
Comprehensive loss	\$(9,498)	\$(6,991)	\$(28,753)	\$(16,654)
Net loss per common share, basic and diluted	\$(0.24)	\$(0.19)	\$(0.73)	\$(0.45)
Weighted average common shares outstanding:				
Basic and diluted	39,870	37,438	39,445	36,774

⁽¹⁾ Includes stock-based compensation expenses as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
Cost of revenues	\$547	\$290	\$1,408	\$706
Sales and marketing	587	399	1,514	1,035
Research and development	766	302	2,050	681
General and administrative	1,459	920	3,849	2,450
Total stock-based compensation expenses	\$3,359	\$1,911	\$8,821	\$4,872

The accompanying notes are an integral part of these condensed consolidated financial statements.

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Q2 HOLDINGS, INC.
 CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
 (unaudited)
 (in thousands)

	Nine Months Ended September 30,	
	2016	2015
Cash flows from operating activities:		
Net loss	\$(28,841)	\$(16,643)
Adjustments to reconcile net loss to net cash (used in) provided by operating activities:		
Amortization of deferred implementation, solution and other costs	4,928	3,750
Depreciation and amortization	8,935	4,429
Amortization of debt issuance costs	72	72
Amortization of premiums on investments	324	225
Stock-based compensation expenses	8,821	4,872
Deferred income taxes	208	—
Allowance for sales credits	29	37
Loss on disposal of long-lived assets	102	—
Unoccupied lease charges	33	—
Changes in operating assets and liabilities:		
Accounts receivable, net	(7,265)	(3,420)
Prepaid expenses and other current assets	(2,062)	326
Deferred solution and other costs	(6,617)	(4,679)
Deferred implementation costs	(4,784)	(3,064)
Other long-term assets	(109)	137
Accounts payable	1,361	1,104
Accrued liabilities	7,841	1,611
Deferred revenues	12,319	11,692
Deferred rent and other long-term liabilities	3,316	(71)
Net cash (used in) provided by operating activities	(1,389)	378
Cash flows from investing activities:		
Purchases of investments	(32,024)	(41,418)
Maturities of investments	34,650	17,418
Purchases of property and equipment	(13,553)	(3,570)
Business combinations, net of cash acquired	(95)	(18,583)
Capitalized software development costs	(1,932)	—
Purchases of other intangible assets	(263)	—
Increase in restricted cash	—	(486)
Net cash used in investing activities	(13,217)	(46,639)
Cash flows from financing activities:		
Payments on financing obligations	(4,890)	(2,873)
Payments on capital lease obligations	(161)	(324)
Proceeds from the issuance of common stock, net of issuance costs	(8)	53,045
Proceeds from exercise of stock options to purchase common stock	4,462	3,623
Shares acquired to settle the exercise of stock options	(223)	(20)
Net cash (used in) provided by financing activities	(820)	53,451
Net (decrease) increase in cash and cash equivalents	(15,426)	7,190
Cash and cash equivalents, beginning of period	67,049	67,979
Cash and cash equivalents, end of period	\$51,623	\$75,169

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Supplemental disclosures of cash flow information:

Cash paid for taxes	\$120	\$60
Cash paid for interest	\$167	\$180
Non-cash investing activities:		
Acquisition consideration payable to seller - working capital adjustment	\$—	\$980

The accompanying notes are an integral part of these condensed consolidated financial statements.

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Q2 HOLDINGS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (unaudited)

(in thousands, except per share amounts and unless otherwise indicated)

1. Organization and Description of Business

Q2 Holdings, Inc. and its wholly-owned subsidiaries, collectively the Company, is a leading provider of secure, cloud-based virtual banking solutions. The Company enables regional and community financial institutions, or RCFIs, to deliver a robust suite of integrated virtual banking services to more effectively engage with their retail and commercial account holders who expect to bank anytime, anywhere and on any device. The Company delivers its solutions to the substantial majority of its customers using a software-as-a-service, or SaaS, model under which its RCFI customers pay subscription fees for the use of the Company's solutions. The Company was incorporated in Delaware in March 2005 and is a holding company that owns 100% of the outstanding capital stock of Q2 Software, Inc. The Company's headquarters are located in Austin, Texas.

2. Summary of Significant Accounting Policies

Basis of Presentation and Principles of Consolidation

As used in this report, the terms "we," "us," "our," or the "Company" refer to Q2 Holdings, Inc. and its direct and indirect wholly-owned subsidiaries. These interim unaudited condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States, or GAAP, and Securities and Exchange Commission, or SEC, requirements for interim financial statements. The interim unaudited condensed consolidated financial statements include the accounts of the Company and its direct and indirect wholly-owned subsidiaries. All intercompany accounts and transactions have been eliminated in consolidation.

In the Company's opinion, the accompanying interim unaudited condensed consolidated financial statements have been prepared on the same basis as the audited consolidated financial statements and include all adjustments, consisting of normal, recurring adjustments, necessary for a fair presentation. Certain information and disclosures normally included in the notes to the annual consolidated financial statements prepared in accordance with GAAP have been omitted from these interim unaudited condensed consolidated financial statements pursuant to the rules and regulations of the SEC. Accordingly, these interim unaudited condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and the accompanying notes for the fiscal year ended December 31, 2015, which are included in the Company's Annual Report on Form 10-K, filed with the SEC on February 12, 2016. The results of operations for the three and nine months ended September 30, 2016 are not necessarily indicative of the results to be expected for the year ending December 31, 2016 or for any other period.

Use of Estimates

The preparation of the accompanying interim unaudited condensed consolidated financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities at the date of the interim unaudited condensed consolidated financial statements, and the reported amounts of revenues and expenses. Significant items subject to such estimates include revenue recognition, stock-based compensation, the carrying value of goodwill, the fair value of acquired intangibles, the capitalization of software development costs, the useful lives of property and equipment and long-lived intangible assets, accruals for compensation for certain employees and shareholders of recent acquisitions, and income taxes. In accordance with GAAP, management bases its estimates on historical experience and on various other assumptions that management believes are reasonable under the circumstances. Management regularly evaluates its estimates and assumptions using historical experience and other factors; however, actual results could differ

significantly from those estimates.

Cash and Cash Equivalents

The Company considers all highly liquid investments acquired with an original maturity of ninety days or less at the date of purchase to be cash equivalents. Cash equivalents are stated at cost or fair value based on the underlying security.

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Q2 HOLDINGS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (unaudited)

(in thousands, except per share amounts and unless otherwise indicated)

Restricted Cash

Restricted cash consists of a deposit held in a checking account for leased office space and amounts collected by the Company on behalf of the customers of its subsidiary Smarty Pig, LLC, doing business as Social Money, or Social Money, which have not yet been remitted. Monies collected on behalf of customers are segregated and used exclusively for remittance to such customers. This usage restriction is internally imposed and reflects the Company's intention with regard to such deposits.

Investments

Investments consist primarily of U.S. government agency bonds, corporate bonds, commercial paper, certificates of deposit and money market funds. All investments are considered available for sale and are carried at fair value.

Concentration of Credit Risk

Financial instruments that potentially subject the Company to concentrations of credit risk consist of cash and cash equivalents, restricted cash, investments and accounts receivable. The Company's cash and cash equivalents, restricted cash and investments are placed with high credit quality financial institutions and issuers, and at times may exceed federally-insured limits. The Company has not experienced any loss relating to cash and cash equivalents or restricted cash in these accounts. The Company provides credit, in the normal course of business, to a number of its customers. The Company performs periodic credit evaluations of its customers' financial condition and generally does not require collateral. No individual customer accounted for 10% or more of revenues for each of the three and nine months ended September 30, 2016 and 2015. No individual customer accounted for 10% or more of accounts receivable, net, as of September 30, 2016 or December 31, 2015.

Accounts Receivable

Accounts receivable are stated at net realizable value, including both billed and unbilled receivables to customers. Unbilled receivable balances arise primarily when the Company provides services in advance of billing for these services and also when the Company earns revenues based on the number of registered users and the number of bill-pay and certain other transactions that registered users perform on the Company's virtual banking solutions in excess of the levels included in the Company's minimum subscription fee. Generally, billing for revenues related to the number of registered users and the number of transactions processed by our registered users occurs one month in arrears. Included in the accounts receivable balances as of September 30, 2016 and December 31, 2015 were unbilled receivables of \$4.8 million and \$3.4 million, respectively.

The Company assesses the collectability of outstanding accounts receivable on an ongoing basis and maintains an allowance for doubtful accounts for accounts receivable deemed uncollectable. As of September 30, 2016 and December 31, 2015, the Company did not provide for an allowance for doubtful accounts, as all amounts outstanding were deemed collectable. Historically, the Company's collection experience has not varied significantly, and bad debt expenses have been insignificant.

The Company maintains a reserve for estimated sales credits issued to customers for billing disputes or other service-related reasons. This allowance is recorded as a reduction against current period revenues and accounts receivable. In estimating this allowance, the Company analyzes prior periods to determine the amounts of sales credits issued to customers compared to the revenues in the period that related to the original customer invoice. This estimate

is analyzed quarterly and adjusted as necessary. The allowance for sales credits was \$0.2 million at each of September 30, 2016 and December 31, 2015.

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Q2 HOLDINGS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (unaudited)

(in thousands, except per share amounts and unless otherwise indicated)

Deferred Implementation Costs

The Company capitalizes certain personnel and other costs, such as employee salaries, benefits and the associated payroll taxes that are direct and incremental to the implementation of its solutions. The Company analyzes implementation costs that may be capitalized to assess their recoverability, and only capitalizes costs that it anticipates to be recoverable. The Company assesses the recoverability of its deferred implementation costs by comparing the greater of the amount of the non-cancellable portion of a customer's contract and the non-refundable customer prepayments received as it relates to the specific implementation costs incurred. The Company begins amortizing the deferred implementation costs for an implementation once the revenue recognition criteria have been met and the Company amortizes those deferred implementation costs ratably over the remaining term of the customer agreement. The portion of deferred implementation costs expected to be amortized during the succeeding twelve-month period is recorded in current assets as deferred implementation costs, current portion, and the remainder is recorded in long-term assets as deferred implementation costs, net of current portion.

Deferred Solution and Other Costs

The Company capitalizes sales commissions and other third-party costs, such as third-party licenses and maintenance related to its customer agreements. The Company capitalizes sales commissions because the commission charges are so closely related to the revenues from the non-cancellable customer agreements that they should be recorded as an asset and charged to expense over the same period that the related revenue is recognized. The Company begins amortizing deferred solution and other costs for a particular customer agreement once the revenue recognition criteria are met and amortizes those deferred costs over the remaining term of the customer agreement. The Company analyzes solution and other costs that may be capitalized to assess their recoverability and only capitalizes costs that it anticipates to be recoverable. The portion of capitalized costs expected to be amortized during the succeeding twelve-month period is recorded in current assets as deferred solution and other costs, current portion, and the remainder is recorded in long-term assets as deferred solution and other costs, net of current portion.

Property and Equipment

Property and equipment are stated at cost less accumulated depreciation and amortization. Depreciation is calculated on a straight-line basis over the estimated useful lives of the related assets. Leasehold improvements are amortized over the shorter of the lease term or the estimated useful lives of the related assets. Maintenance and repairs that do not extend the life of or improve an asset are expensed in the period incurred.

The estimated useful lives of property and equipment are as follows:

Computer hardware and equipment	3 - 5 years
Purchased software and licenses	3 - 5 years
Furniture and fixtures	7 years
Leasehold improvements	Lesser of estimated useful life or lease term

Purchase Price Allocation, Intangible Assets, and Goodwill

The purchase price allocation for business combinations requires extensive use of accounting estimates and judgments to allocate the purchase price to the identifiable tangible and intangible assets acquired and liabilities assumed based on their respective fair values. In connection with the Company's acquisition of Centrix Solutions, Inc., or Centrix, in July 2015 and Social Money in November 2015, the Company recorded certain intangible assets, including acquired

technology, customer relationships, trademarks and non-compete agreements.

Amounts allocated to the acquired intangible assets are being amortized on a straight-line basis over the estimated useful lives. The Company periodically reviews the estimated useful lives and fair values of its identifiable intangible assets, taking into consideration any events or circumstances which might result in a diminished fair value or revised useful life.

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Q2 HOLDINGS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (unaudited)

(in thousands, except per share amounts and unless otherwise indicated)

The excess purchase price over the fair value of assets acquired is recorded as goodwill. The Company tests goodwill for impairment annually in October, or whenever events or changes in circumstances indicate an impairment may have occurred. Because the Company operates in a single reporting unit, the impairment test is performed at the consolidated entity level by comparing the estimated fair value of the Company to the carrying value of the Company. Impairment evaluations involve the Company's assessment of qualitative factors to determine whether it is more likely than not that goodwill is impaired. If the Company concludes from its assessment of qualitative factors that it is more likely than not that impairment exists, then a quantitative impairment test will be performed involving management estimates of asset useful lives and future cash flows. Significant judgment is required in the forecasts of future operating results that are used in these evaluations. If actual results, or the plans and estimates used in future impairment analysis are lower than the original estimates used to assess the recoverability of these assets, the Company could incur impairment charges in a future period.

Deferred Revenues

Deferred revenues primarily consist of amounts that have been billed to or received from customers in advance of revenue recognition and prepayments received from customers in advance for implementation, maintenance and other services, as well as initial subscription fees. The Company recognizes deferred revenues as revenues when the services are performed and the corresponding revenue recognition criteria are met. Customer prepayments are generally applied against invoices issued to customers when services are performed and billed. Deferred revenues that are expected to be recognized as revenues during the succeeding twelve-month period are recorded in current liabilities as deferred revenues, current portion, and the remaining portion is recorded in long-term liabilities as deferred revenues, net of current portion.

Revenues

All revenue-generating activities are directly related to the sale, implementation and support of the Company's solutions within a single operating segment. The Company derives the substantial majority of its revenues from subscription fees for the use of its solutions hosted in the Company's data centers as well as revenues for implementation and customer support services related to the Company's solutions. A small portion of the Company's customers host the Company's solutions in their own data centers under term license and maintenance agreements, and the Company recognizes the corresponding revenues ratably over the term of those customer agreements.

Revenues are recognized net of sales credits and allowances. The Company begins to recognize revenues for a customer when all of the following criteria are satisfied:

- there is persuasive evidence of an arrangement;
- the service has been or is being provided to the customer;
- the collection of the fees is reasonably assured; and
- the amount of fees to be paid by the customer is fixed or determinable.

Determining whether and when these criteria have been met can require significant judgment and estimates. In general, revenue recognition commences when the Company's solutions are implemented and made available to the customers.

The Company's software solutions are available for use in hosted application arrangements under subscription fee agreements. Subscription fees from these applications, including related customer support, are recognized ratably over the customer agreement term beginning on the date the solution is made available to the customer. Amounts that have been invoiced are recorded in accounts receivable and deferred revenues or revenues, depending on whether the Company's revenue recognition criteria have been met.

The Company considers subscription fees to be fixed or determinable unless the fees are subject to refund or adjustment or are not payable within the Company's standard payment terms. In determining whether collection of subscription fees is reasonably assured, the Company considers financial and other information about customers, such as a customer's current credit-worthiness and payment history over time. Historically, bad debt expenses have not been significant.

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Q2 HOLDINGS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (unaudited)

(in thousands, except per share amounts and unless otherwise indicated)

The Company enters into arrangements with multiple-deliverables that generally include multiple subscriptions and implementation services. Additional agreements with existing customers that are not in close proximity to the original arrangements are treated as separate contracts for accounting purposes.

For multiple-deliverable arrangements, arrangement consideration is allocated to deliverables based on their relative selling price. In order to treat deliverables in a multiple-deliverable arrangement as separate units of accounting, the deliverables must have standalone value upon delivery. The Company's subscription services have standalone value as such services are often sold separately. In determining whether implementation services have standalone value apart from the subscription services, the Company considers various factors including the availability of the services from other vendors. To date, the Company has concluded that the implementation services included in multiple-deliverable arrangements do not have standalone value. As a result, when implementation services are sold in a multiple-deliverable arrangement, the Company defers any arrangement fees for implementation services and recognizes such amounts ratably over the period of performance for the initial agreement term.

When multiple-deliverables included in an arrangement are separated into different units of accounting, the arrangement consideration is allocated to the identified separate units based on a relative selling price hierarchy. The selling price for a deliverable is based on its vendor-specific objective evidence of selling price, or VSOE, if available, third-party evidence of selling price, or TPE, if VSOE is not available or best estimate of selling price, or BESP, if neither VSOE nor TPE is available. The Company has not established VSOE for its subscription services due to lack of pricing consistency, the introduction of new services and other factors. The Company has determined that TPE is not a practical alternative due to differences in its service offerings compared to other parties and the availability of relevant third-party pricing information. Accordingly, the Company uses BESP to determine the relative selling price. The amount of revenue allocated to delivered items is limited by contingent revenues.

The Company determines BESP by considering its overall pricing objectives and market conditions. Significant pricing practices taken into consideration include the Company's discounting practices, the size and volume of its transactions, customer characteristics, price lists, go-to-market strategy, historical standalone sales and agreement prices. As the Company's go-to-market strategies evolve, it may modify its pricing practices in the future, which could result in changes in relative selling prices, and include both VSOE and BESP.

Subscription Fee Revenues

The Company's solutions are available as hosted solutions under subscription fee agreements without licensing perpetual rights to the software. Subscription fees from a hosted solution are recognized monthly over the customer agreement term beginning on the date the Company's solution is made available to the customer. Additional fees for monthly usage above the levels included in the standard subscription fee, which include fees for transactions processed during the period, are recognized as revenue in the month when the usage amounts are determined and reported. Any revenues related to upfront implementation services are recognized ratably over the same customer agreement term. Amounts that have been invoiced are recorded in accounts receivable and deferred revenues or revenues, depending on whether the revenue recognition criteria have been met.

Professional Services Revenues

When professional services are not combined with subscription services or term licenses as a single unit of accounting, these professional services revenues are recognized as the services are performed.

Certain out-of-pocket expenses billed to customers are recorded as revenues rather than an offset to the related expense. Revenues recorded from out-of-pocket expense reimbursements totaled approximately \$0.4 million and \$0.3 million for the three months ended September 30, 2016 and 2015, respectively, and \$1.2 million and \$0.9 million for the nine months ended September 30, 2016 and 2015, respectively. The out-of-pocket expenses are reported in cost of revenues.

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Q2 HOLDINGS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (unaudited)

(in thousands, except per share amounts and unless otherwise indicated)

Term Licenses and Maintenance Revenues

A small portion of the Company's customers host and manage the Company's solutions on-premises or in third-party data centers under term license and maintenance agreements. Term licenses sold with maintenance, which entitles the customer to technical support and upgrades and updates to the software made available on a when-and-if-available basis, are accounted for under Accounting Standards Codification, or ASC, 985-605, "Software Revenue Recognition." The Company does not have VSOE of fair value for the maintenance and professional services so the entire arrangement consideration is recognized monthly over the term of the software license when all of the other revenue recognition criteria have been met. Revenues from term licenses and maintenance agreements were not significant in the periods presented.

Cost of Revenues

Cost of revenues is comprised primarily of salaries and other personnel-related costs, including employee benefits, bonuses and stock-based compensation, for employees providing services to the Company's customers. Costs associated with these services include the costs of the Company's implementation, customer support, data center and customer training personnel. Cost of revenues also includes the direct costs of bill-pay and other third-party intellectual property included in the Company's solutions, the amortization of deferred solution and services costs, co-location facility costs and depreciation of the Company's data center assets, an allocation of general overhead costs and referral fees. Direct costs of third-party intellectual property include amounts paid for third-party licenses and related maintenance that are incorporated into the Company's software and the amortization of acquired technology from the Company's recent acquisitions, with the costs amortized to cost of revenues over the useful lives of the purchased assets.

The Company capitalizes certain personnel costs directly related to the implementation of its solutions to the extent those costs are considered to be recoverable from future revenues. The Company amortizes the costs for a particular implementation once revenue recognition commences, and the Company amortizes those implementation costs over the remaining term of the customer agreement. Other costs not directly recoverable from future revenues are expensed in the period incurred. The Company capitalized implementation costs in the amount of \$1.7 million and \$1.0 million during the three months ended September 30, 2016 and 2015, respectively, and \$4.8 million and \$3.1 million during the nine months ended September 30, 2016 and 2015, respectively.

Software Development Costs

Software development costs include salaries and other personnel-related costs, including employee benefits and bonuses attributed to programmers, software engineers and quality control teams working on the Company's software solutions. The costs related to software development that are incurred between reaching technological feasibility of a solution and the point at which the solution is ready for general release are capitalized and are included in intangible assets, net on the condensed consolidated balance sheet. Amortization of capitalized software development costs will be computed on an individual product basis for those products available for market and will be recognized based on the product's estimated economic life and these costs will be recognized in cost of revenues. As of September 30, 2016, no amortization of capitalized software development costs has been recognized as none of the related individual products have reached general release. The Company capitalized software development costs in the amount of \$0.7 million and zero during the three months ended September 30, 2016 and 2015, respectively, and \$1.9 million and zero during the nine months ended September 30, 2016 and 2015, respectively.

Research and Development Costs

Research and development costs include salaries and other personnel-related costs, including employee benefits, bonuses and stock-based compensation, third-party contractor expenses, software development tools, an allocation of facilities and depreciation expenses and other related expenses incurred in developing new solutions and upgrading and enhancing existing solutions. Research and development costs are expensed as incurred.

Advertising

All advertising costs of the Company are expensed the first time the advertising takes place. Advertising costs were \$0.1 million for each of the three months ended September 30, 2016 and 2015 and were \$0.2 million for each of the nine months ended September 30, 2016 and 2015.

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Sales Tax

The Company presents sales taxes and other taxes collected from customers and remitted to governmental authorities on a net basis and, as such, excludes them from revenues.

Comprehensive Loss

Comprehensive loss includes net loss as well as other changes in stockholders' equity that result from transactions and economic events other than those with stockholders. Other comprehensive loss consists of net loss and unrealized gains and losses on available-for-sale investments.

Stock-Based Compensation

Stock options and restricted stock units awarded to employees, directors and consultants are measured at fair value at each grant date. The Company recognizes compensation expense ratably over the requisite service period of the option or restricted stock unit award, net of the expected forfeitures. The forfeiture rate is estimated at grant date based on historical experience and adjusted in subsequent periods for differences in actual forfeitures for those estimates. Generally, options vest 25% on the one-year anniversary of the grant date with the balance vesting monthly over the following 36 months, and restricted stock unit awards vest in four annual installments of 25% beginning on the one-year anniversary of the grant date.

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

The Company values restricted stock units at the closing market price on date of grant, and recognizes compensation expense ratably over the requisite service period of the restricted stock unit award, net of the expected forfeitures.

Income Taxes

Deferred income taxes are provided for the tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes and operating loss carryforwards and credits using enacted tax rates expected to be in effect in the years in which the differences are expected to reverse. The Company assesses the likelihood that deferred tax assets will be realized and recognizes a valuation allowance if it is more likely than not that some portion of the deferred tax assets will not be realized. This assessment requires judgment as to the likelihood and amounts of future taxable income by tax jurisdiction. To date,

the Company has provided a full valuation allowance against its deferred tax assets as it believes the objective and verifiable evidence of its historical pretax net losses outweighs any positive evidence of its forecasted future results. Although the Company believes that its tax estimates are reasonable, the ultimate tax determination involves significant judgment that is subject to audit by tax authorities in the ordinary course of business. The Company will continue to monitor the positive and negative evidence, and it will adjust the valuation allowance as sufficient objective positive evidence becomes available.

The Company evaluates its uncertain tax positions based on a determination of whether and how much of a tax benefit taken by the Company in its tax filings or positions is more likely than not to be realized. Potential interest and penalties associated with any uncertain tax positions are recorded as a component of income tax expense. Through September 30, 2016, the Company has not identified any material uncertain tax positions for which liabilities would be required to be recorded.

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Basic and Diluted Net Loss per Common Share

The following table sets forth the computations of loss per share for the periods listed:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
Numerators:				
Net loss	\$ (9,481)	\$ (7,016)	\$ (28,841)	\$ (16,643)
Denominator:				
Weighted-average common shares outstanding, basic and diluted	39,870	37,438	39,445	36,774
Net loss per common share, basic and diluted	\$ (0.24)	\$ (0.19)	\$ (0.73)	\$ (0.45)

Due to net losses for each of the three and nine months ended September 30, 2016 and 2015, basic and diluted net loss per share were the same, as the effect of all potentially dilutive securities would have been anti-dilutive. The following table sets forth the anti-dilutive common share equivalents that were excluded for the periods listed:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
Stock options and restricted stock units	5,981	5,831	5,981	5,831

Recent Accounting Pronouncements

In May 2014, the Financial Accounting Standards Board, or FASB, issued Accounting Standards Update, or ASU, No. 2014-09, "Revenue from Contracts with Customers (Topic 606)," or ASU 2014-09, which amends the existing accounting standards for revenue recognition. ASU 2014-09 is based on principles that govern the recognition of revenue at an amount an entity expects to be entitled to when products are transferred to customers. In August 2015, the FASB issued ASU No. 2015-14, "Revenue from Contracts with Customers (Topic 606): Deferral of the Effective Date," or ASU 2015-14, that deferred the effective date by one year to December 15, 2017 for interim and annual reporting periods beginning after that date. The FASB permitted early adoption of the standard, but not before the original effective date of December 15, 2016. ASU 2015-14 will be effective for the Company beginning in its first quarter of 2018. Early adoption is permitted beginning in 2017. The new revenue standard may be applied retrospectively to each prior period presented or prospectively with the cumulative effect recognized as of the date of adoption. The Company is currently evaluating how the adoption of this standard will impact its condensed consolidated financial statements.

In April 2015, the FASB issued ASU No. 2015-03, "Interest - Imputation of Interest (Subtopic 835-30)," or ASU 2015-03, which seeks to simplify the presentation of debt issuance costs. ASU 2015-03 requires that debt issuance costs be classified as a contra-liability against any outstanding borrowings related to such debt issuance costs, rather than as a separate asset. In August 2015, the FASB issued ASU No. 2015-15, "Interest - Imputation of Interest (Subtopic 835-30)," to update ASU 2015-03 and apply accounting guidance to line-of-credit arrangements. The Company adopted this standard as of March 31, 2016, and its adoption did not have any impact to the condensed consolidated financial statements.

In April 2015, the FASB issued ASU No. 2015-05, "Intangibles - Goodwill and Other - Internal-Use Software (Subtopic 350-40)," related to accounting for fees paid in a cloud computing arrangement. The new standard provides guidance to customers about whether a cloud computing arrangement includes a software license. If a cloud computing arrangement includes a software license, then the customer should account for the software license element of the arrangement consistent with the acquisition of other software licenses. If a cloud computing arrangement does not include a software license, the customer should account for the arrangement as a service contract. The Company adopted this standard as of March 31, 2016, and its adoption did not have any impact to the condensed consolidated financial statements.

In September 2015, the FASB issued ASU No. 2015-16, "Business Combinations (Topic 805): Simplifying the Accounting for Measurement-Period Adjustments." The amendments in this update require that an acquirer recognize adjustments to provisional amounts that are identified during the measurement period with a corresponding adjustment to

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goodwill in the reporting period in which the adjustment amounts are determined. The effect on earnings from changes in depreciation, amortization or other income effects, if any, as a result of the change to the provisional amounts will be recorded in the same period's financial statements, calculated as if the accounting had been completed at the acquisition date. The Company adopted this standard as of March 31, 2016, and its adoption did not have any impact to the condensed consolidated financial statements.

In February 2016, the FASB issued ASU No. 2016-02, "Leases (Topic 842)," to increase transparency and comparability among organizations by recognizing lease assets and lease liabilities on the balance sheet and disclosing key information about leasing arrangements. The standard is effective for public entities for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years, and early application is permitted. The Company is currently evaluating how the adoption of this standard will impact its condensed consolidated financial statements.

In March 2016, the FASB issued ASU No. 2016-09, "Improvements to Employee Share-Based Payment Accounting," or ASU 2016-09, which amends ASC Topic 718, "Compensation – Stock Compensation." ASU 2016-09 simplifies several aspects of the accounting for share-based payment transactions, including the income tax consequences, classification of awards as either equity or liabilities, and classification on the statement of cash flows. The standard is effective for fiscal years beginning after December 15, 2016, and interim periods within those fiscal years and early adoption is permitted. The Company is currently evaluating how the adoption of this standard will impact its condensed consolidated financial statements.

In August 2016, the FASB issued ASU No. 2016-15, "Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments," to clarify and provide specific guidance on eight cash flow classification issues that are not addressed by current GAAP and thereby reduce the current diversity in practice. The standard is effective for fiscal years beginning after December 15, 2017, and interim periods within those fiscal years and early adoption is permitted. The Company is currently evaluating how the adoption of this standard will impact its condensed consolidated financial statements.

3. Business Combinations

During 2015, the Company acquired all of the outstanding shares of Centrix, a privately owned company that provides financial institutions with products that detect fraud, manage risk and simplify compliance and acquired all of the outstanding ownership interests of Social Money, a privately owned financial services software company that offers a modern, cloud-based platform that assists financial institutions in their direct digital strategies.

The former shareholders of Centrix have the right to receive in the aggregate up to \$9.0 million based upon the achievement of certain milestone-based objectives and the continued employment of certain shareholders. Payouts under these agreements are contingent upon the future employment of these Centrix employees with the Company and were therefore not included as consideration in recording the business combination but will be recorded as compensation expense as earned. The Company has recognized approximately \$1.8 million and \$4.4 million under these agreements in compensation expense included in acquisition related costs in the condensed consolidated statement of comprehensive loss for the three and nine months ended September 30, 2016, respectively, and \$0.8 million for each of the three and nine months ended September 30, 2015. The unpaid amounts due to the former shareholders are recorded in accrued compensation in the condensed consolidated balance sheets.

Former key employees of Social Money have the right to receive in the aggregate up to \$0.3 million based upon continued employment. Payouts under these agreements are contingent upon the future employment of these key employees with the Company and were therefore not included as consideration in recording the business combination but will be recorded as compensation expense as earned. The Company has recognized \$0.1 million and \$0.2 million under these agreements in compensation expense included in acquisition related costs in the condensed consolidated statement of comprehensive loss for the three and nine months ended September 30, 2016, respectively, and zero for each of the three and nine months ended September 30, 2015. The unpaid amounts due to the former key employees are recorded in accrued compensation in the condensed consolidated balance sheets.

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4. Fair Value Measurements

The carrying values of the Company's financial instruments, principally cash equivalents, investments, accounts receivable, restricted cash and accounts payable, approximated their fair values due to the short period of time to maturity or repayment.

Fair value is defined as the exchange price that would be received for an asset or an exit price paid to transfer a liability in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. Valuation techniques used to measure fair value must maximize the use of observable inputs and minimize the use of unobservable inputs. The current accounting guidance for fair value measurements defines a three-level valuation hierarchy for disclosures as follows:

Level 1—Unadjusted quoted prices in active markets for identical assets or liabilities;

Level 2—Inputs other than quoted prices included within Level 1 that are observable, unadjusted quoted prices in markets that are not active, or other inputs that are observable or can be corroborated by observable market data; and

Level 3—Unobservable inputs that are supported by little or no market activity, which requires the Company to develop its own assumptions.

The categorization of a financial instrument within the valuation hierarchy is based upon the lowest level of input that is significant to the fair value measurement.

The following table details the fair value hierarchy of the Company's financial assets measured at fair value on a recurring basis as of September 30, 2016:

		Fair Value Measurements Using:		
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Cash Equivalents:	Fair Value			
Money market funds	\$9,795	\$9,795	\$ —	\$ —
Investments:	Fair Value	Quoted Prices in Active Markets for Identical Assets	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)

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		(Level 1)			
U.S. government agency bonds	\$ 13,044	\$—	\$ 13,044	\$	—
Corporate bonds and commercial paper	12,095	—	12,095	—	
Certificates of deposit	15,569	—	15,569	—	
	\$40,708	\$—	\$ 40,708	\$	—

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The following table details the fair value hierarchy of the Company's financial assets measured at fair value on a recurring basis as of December 31, 2015:

	Fair Value	Fair Value Measurements Using:		
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Cash Equivalents:				
Money market funds	\$6,860	\$6,860	\$ —	\$ —
Investments:				
U.S. government agency bonds	\$13,006	\$—	\$ 13,006	\$ —
Corporate bonds and commercial paper	17,845	—	17,845	—
Certificates of deposit	12,720	—	12,720	—
	\$43,571	\$—	\$ 43,571	\$ —

The Company determines the fair value of its investment holdings based on pricing from our pricing vendors. The valuation techniques used to measure the fair value of financial instruments having Level 2 inputs were derived from non-binding consensus prices that are corroborated by observable market data or quoted market prices for similar instruments. Such market prices may be quoted prices in active markets for identical assets (Level 1 inputs) or pricing determined using inputs other than quoted prices that are observable either directly or indirectly (Level 2 inputs).

5. Cash, Cash Equivalents and Investments

The Company's cash, cash equivalents and investments as of September 30, 2016 and December 31, 2015 consisted primarily of cash, U.S. government agency bonds, corporate bonds, commercial paper, certificates of deposit and money market funds.

The Company classifies investments as available-for-sale at the time of purchase and reevaluates such classification as of each balance sheet date. All investments are recorded at estimated fair value. Unrealized gains and losses on available-for-sale investments are included in accumulated other comprehensive loss, a component of stockholders' equity. The Company evaluates its investments to assess whether those with unrealized loss positions are other than

temporarily impaired. The Company considers impairments to be other than temporary if they are related to deterioration in credit risk or if it is likely the Company will sell the investments before the recovery of their cost basis. Realized gains and losses and declines in value judged to be other than temporary are determined based on the specific identification method and are reported in other income (expense), net, in the condensed consolidated statements of comprehensive loss. Interest, amortization of premiums and accretion of discount on all investments classified as available-for-sale are also included as a component of other income (expense), net, in the condensed consolidated statements of comprehensive loss.

As of September 30, 2016 and December 31, 2015, the Company's cash was \$41.8 million and \$60.2 million, respectively.

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A summary of the Company's cash equivalents and investments as of September 30, 2016 is as follows:

Cash Equivalents:	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Money market funds	\$ 9,795	\$ —	\$ —	\$ 9,795
Investments:	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
U.S. government agency bonds	\$ 13,049	\$ 1	\$ (6)	\$ 13,044
Corporate bonds and commercial paper	12,103	2	(10)	12,095
Certificates of deposit	15,569	—	—	15,569
	\$ 40,721	\$ 3	\$ (16)	\$ 40,708

A summary of the Company's cash equivalents and investments as of December 31, 2015 is as follows:

Cash Equivalents:	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Money market funds	\$ 6,860	\$ —	—\$ —	\$ 6,860
Investments:	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
U.S. government agency bonds	\$ 13,044	\$ —	—\$ (38)	\$ 13,006
Corporate bonds and commercial paper	17,908	—	(63)	17,845
Certificates of deposit	12,720	—	—	12,720
	\$ 43,672	\$ —	—\$ (101)	\$ 43,571

The Company may sell its investments at any time, without significant penalty, for use in current operations or for other purposes, even if they have not yet reached maturity. As a result, the Company classifies its investments, including investments with maturities beyond twelve months, as current assets in the accompanying condensed consolidated balance sheets.

The following table summarizes the estimated fair value of the Company's investments, designated as available-for-sale and classified by the contractual maturity date of the investments as of the dates shown:

	September 30, 2016	December 31, 2015
Due within one year or less	\$ 23,714	\$ 22,737
Due after one year through five years	16,994	20,834
	\$ 40,708	\$ 43,571

The Company has certain available-for-sale investments in a gross unrealized loss position, all of which have been in such position for less than twelve months. The Company reviews its debt securities classified as short-term investments on a regular basis to evaluate whether or not any security has experienced an other than temporary decline in fair value. The Company considers factors such as the length of time and extent to which the market value has been less than the cost, the financial position and near-term prospects of the issuer and its intent to sell, or whether it is

more likely than not the Company will be required to sell the investment before recovery of the investment's amortized-cost basis. If the Company determines that an other than temporary decline exists in one of these investments, the respective investment would be written down to fair value. For debt securities, the portion of the write-down related to credit loss would be recognized in other income, net in the condensed consolidated statements of comprehensive loss. Any portion not related to credit loss would be included in accumulated other comprehensive loss. Because the Company does not intend to sell any investments which have an unrealized

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loss position at this time, and it is not more likely than not that the Company will be required to sell the investment before recovery of its amortized cost basis, which may be maturity, the Company does not consider the investments with unrealized loss positions to be other than temporarily impaired as of September 30, 2016.

The following table shows the fair values and the gross unrealized losses of these available-for-sale investments aggregated by investment category as of September 30, 2016:

	Adjusted Cost	Gross Unrealized Loss	Fair Value
U.S. government agency bonds	\$8,022	\$ (6)	\$8,016
Corporate bonds and commercial paper	10,095	(10)	10,085
	\$18,117	\$ (16)	\$18,101

The following table shows the fair values and the gross unrealized losses of these available-for-sale investments aggregated by investment category as of December 31, 2015:

	Adjusted Cost	Gross Unrealized Loss	Fair Value
U.S. government agency bonds	\$13,044	\$ (38)	\$13,006
Corporate bonds and commercial paper	16,907	(63)	16,844
	\$29,951	\$ (101)	\$29,850

6. Goodwill and Intangible Assets

The carrying amount of goodwill was \$12.9 million at September 30, 2016 and December 31, 2015. Goodwill represents the excess purchase price over the fair value of assets acquired. During 2015, the Company completed the acquisitions of Centrix and Social Money. The Company has one operating segment and one reporting unit. Goodwill is tested for impairment on an annual basis, and between annual tests if indicators of potential impairment exist, using a fair-value-based approach based on the market capitalization of the reporting unit, and no impairment of goodwill has been recorded to date. Goodwill is deductible for tax purposes in certain jurisdictions.

The Company recorded intangible assets from the acquisitions in 2015, discussed in Note 3, Business Combinations. Intangible assets are amortized on a straight-line basis over their estimated useful lives, which range from two to six years. Amortization expense included in cost of revenues in the condensed consolidated statement of comprehensive loss was \$0.8 million and \$0.2 million for the three months ended September 30, 2016 and 2015, respectively, and \$2.4 million and \$0.2 million for the nine months ended September 30, 2016 and 2015, respectively. Amortization expense included in operating expenses in the condensed consolidated statement of comprehensive loss was \$0.4 million and \$0.2 million for the three months ended September 30, 2016 and 2015, respectively and \$1.1 million and \$0.2 million for the nine months ended September 30, 2016 and 2015, respectively.

Software development costs capitalized as of September 30, 2016 were \$2.2 million and \$0.3 million as of December 31, 2015. As these software products have not reached general release, the Company has not commenced amortization of these costs. Amortization of capitalized software development costs will be computed on an individual product basis for those products available for market and will be recognized based on the product's estimated economic life and these costs will be recognized in cost of revenues.

7. Debt

In April 2013, the Company entered into a secured credit facility agreement, or Credit Facility, with Wells Fargo Bank, National Association, or Wells Fargo, which the Company and Wells Fargo subsequently amended several times, most recently on March 31, 2016, to modify the Credit Facility to allow for the acquisition of Social Money. The Credit Facility, as amended, provides for a line of credit of up to \$25.0 million, with an accordion feature, or Accordion Feature, allowing the Company to

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increase its maximum borrowings by up to an additional \$25.0 million, subject to certain conditions and limitations, including that borrowings at any time shall be limited to 75% of the Company's trailing twelve-month recurring revenues. Access to the total borrowings available under the Credit Facility is restricted based on covenants related to the Company's minimum liquidity and adjusted EBITDA. Amounts borrowed under the Credit Facility accrue interest, at the Company's election at either: (i) the per annum rate equal to the LIBOR rate plus an applicable margin; or (ii) the current base rate plus the greater of the U.S. Federal Funds rate plus one percentage point, the one-month LIBOR plus one percentage point, or the lending financial institution's prime rate. The Company pays a monthly fee based on the total unused borrowings balance, an annual administrative fee and the initial closing fee, which was paid in three equal annual installments over the first three years of the Credit Facility. The Accordion Feature expired on October 11, 2016, at which time maximum borrowings under the Facility were reduced to \$25.0 million, and the Credit Facility matures in April 2017, at which time any outstanding borrowings and accrued interest become payable.

As of September 30, 2016, the Company had no borrowings outstanding and only a secured letter of credit of \$3.0 million against the Credit Facility, leaving an available balance of approximately \$22.0 million. The interest rate applicable to the Credit Facility was 3.5%. The Credit Facility is collateralized by substantially all of the Company's assets and requires that the Company maintain certain financial covenants as provided in the Credit Facility. The Company was in compliance with all financial covenants as of September 30, 2016.

8. Commitments and Contingencies

Operating Lease Commitments

The Company leases office space under non-cancellable operating leases for its corporate headquarters in Austin, Texas in two adjacent buildings under separate lease agreements, pursuant to the first of which the Company leases approximately 67 square feet of office space with an initial term that expires on April 30, 2021, with the option to extend the lease for an additional five-year term, and pursuant to the second of which the Company leases approximately 129 square feet of office space with an initial term that expires on April 30, 2028, with the option to extend the lease for an additional ten-year term. The Company also leases office space in: Lincoln, Nebraska; Des Moines, Iowa; Atlanta, Georgia; Asheville, North Carolina; and south Austin, Texas. We believe our current facilities will be adequate for our needs for the foreseeable future. Rent expense under operating leases was \$0.9 million and \$0.5 million for the three months ended September 30, 2016 and 2015, respectively, and \$2.8 million and \$1.1 million for the nine months ended September 30, 2016 and 2015, respectively.

Future minimum payments required under operating leases that have initial or remaining non-cancelable lease terms in excess of one year at September 30, 2016 were as follows:

	Operating Leases
Year Ended December 31,	
2016 (from October 1 to December 31)	\$ 1,210
2017	5,494
2018	5,536
2019	5,538
2020	5,563
Thereafter	29,420
Total minimum lease payments	\$ 52,761

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Contractual Commitments

The Company has non-cancelable contractual commitments related to third-party products, co-location fees and other product costs. Future minimum contractual commitments that have initial or remaining non-cancelable terms in excess of one year were as follows:

	Contractual Commitments
Year Ended December 31,	
2016 (from October 1 to December 31)	\$ 2,070
2017	7,937
2018	7,285
2019	6,061
2020	5,437
Thereafter	—
Total commitments	\$ 28,790

Legal Proceedings

From time to time, the Company may become involved in legal proceedings arising in the ordinary course of its business. The Company is not presently a party to any legal proceedings that, if determined adversely to the Company, would have a material adverse effect on the Company.

9. Stock-Based Compensation

In March 2014, the Company's board of directors approved the 2014 Equity Incentive Plan, or 2014 Plan, under which stock options, stock appreciation rights, restricted stock, restricted stock units, performance shares and units and other cash-based or stock-based awards may be granted to employees, consultants and directors. Shares of common stock that are issued and available for issuance under the 2014 Plan consist of authorized, but unissued or reacquired shares of common stock or any combination thereof.

As of December 31, 2015, a total of 3,628 shares had been reserved for issuance under the 2014 Plan. The 2014 Plan contains a provision that automatically increases the shares available for issuance under the plan on January 1 of each year subsequent to the 2014 Plan's adoption through 2024, by an amount equal to the smaller of (a) 4.5% of the number of shares of common stock issued and outstanding on the immediately preceding December 31, or (b) an amount determined by the Company's board of directors. On January 1, 2016, 1,750 shares were added to the 2014 Plan in accordance with the annual automatic increase provision of the 2014 Plan. In addition, the 2014 Plan reserve is automatically increased to include any shares issuable upon expiration or termination of options granted under the Company's 2007 Stock Plan, or 2007 Plan, for options that expire or terminate without having been exercised. For the nine months ended September 30, 2016, 19 shares have been transferred to the 2014 Plan from the 2007 Plan, and as of September 30, 2016 a total of 5,397 shares were allocated for issuance under the 2014 Plan. As of September 30, 2016, options to purchase a total of 2,040 shares of common stock have been granted under the 2014 Plan, 1,444 shares have been reserved under the 2014 Plan for the vesting of restricted stock units, 146 shares have been returned to the 2014 Plan as a result of termination of options that expired or terminated without having been exercised and restricted stock awards that terminated prior to the awards vesting, and 2,059 shares of common stock remain available for future issuance under the 2014 Plan.

In July 2007, the Company adopted the 2007 Plan under which options or stock purchase rights may be granted to employees, consultants and directors. Upon the completion of the Company's initial public offering, or IPO, in March 2014, the board of directors terminated the 2007 Plan in connection with the IPO and all shares that were available for future issuance under the 2007 Plan at such time were transferred to the 2014 Plan. The 2007 Plan will continue to govern the terms and conditions of all outstanding equity awards granted under the 2007 Plan. As of September 30, 2016, no shares remain available for future issuance under the 2007 Plan. Shares of common stock that are issued and

were available for issuance under the 2007 Plan consist of authorized, but unissued or reacquired shares of common stock or any combination thereof.

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Q2 HOLDINGS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (unaudited)

(in thousands, except per share amounts and unless otherwise indicated)

Stock Options

Stock option activity during the nine months ended September 30, 2016 was as follows:

	Number of Options	Weighted Average Exercise Price
Balance as of January 1, 2016	5,044	\$ 8.84
Granted	880	23.41
Exercised	(1,093)	4.28
Forfeited	(67)	16.93
Balance as of September 30, 2016	4,764	\$ 12.46

Restricted Stock Units

Restricted stock unit activity during the nine months ended September 30, 2016 was as follows:

	Number of Shares	Weighted Average Grant Date Fair Value
Nonvested as of January 1, 2016	716	\$ 26.19
Granted	708	25.28
Vested	(141)	26.12
Forfeited	(66)	26.27
Nonvested as of September 30, 2016	1,217	\$ 25.66

10. Income Taxes

In accordance with applicable accounting guidance, the income tax provision for the three and nine months ended September 30, 2016 is based on the estimated annual effective tax rate for fiscal year 2016. The estimated effective tax rate may be subject to adjustment in subsequent quarterly periods as the estimates of pretax income for the year, along with other items that may affect the rate, change.

For the three months ended September 30, 2016 and 2015, the Company's provision for income taxes reflected an effective tax rate of approximately 1.0% and 1.1%, respectively. For the nine months ended September 30, 2016 and 2015, the Company's provision for income taxes reflected an effective tax rate of approximately 1.2% and 0.7%, respectively. For the three and nine months ended September 30, 2016 and 2015, the Company's effective tax rate was lower than the U.S. federal statutory rate primarily due to changes to its valuation allowance.

The Company has significant deferred tax assets related to its net operating loss carryforwards and tax credits and has provided a valuation allowance for the full amount of its deferred tax assets, as it is not more likely than not that any future benefit from deductible temporary differences, net operating loss carryforwards, and tax credit carryforwards will be realized. This assessment requires judgment as to the likelihood and amounts of future taxable income by tax jurisdiction.

To date, the Company has provided a full valuation allowance against its deferred tax assets as it believes the objective and verifiable evidence of its historical pretax net losses outweighs any positive evidence of its forecasted future results. Although the Company believes that its tax estimates are reasonable, the ultimate tax determination involves significant judgment that is subject to audit by tax authorities in the ordinary course of business. The Company will continue to monitor the positive and negative evidence, and it will adjust the valuation allowance as sufficient objective positive evidence becomes available.

The Company had no unrecognized tax benefits as of September 30, 2016. The Company's tax years 2012 through 2015 remain open to examination by the major taxing jurisdictions to which the Company is subject. However, the Company is not currently under examination by any taxing jurisdiction.

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

Special Note Regarding Forward-Looking Statements

This Quarterly Report on Form 10-Q contains forward-looking statements that are based on our management's beliefs and assumptions and on information currently available to our management. The statements contained in this Quarterly Report on Form 10-Q that are not purely historical are forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995, Section 27A of the Securities Act of 1933, as amended, or the Securities Act, and Section 21E of the Securities Exchange Act of 1934, as amended, or the Exchange Act. You can identify these statements by words such as "anticipates," "believes," "can," "continue," "could," "estimates," "expects," "intends," "may," "plans," "seeks," "should," "will," "strategy," "future," "likely," or "would" or the negative of these terms or similar expressions. These statements are not guarantees of future performance or development and involve known and unknown risks, uncertainties and other factors that are in some cases beyond our control. All of our forward-looking statements are subject to risks and uncertainties that may cause our actual results to differ materially from our expectations. Factors that may cause such differences include, but are not limited to, the risks described under "Risk Factors" in our Annual Report on Form 10-K for the year ended December 31, 2015 and in this Quarterly Report on Form 10-Q and those discussed in other documents we file with the Securities and Exchange Commission, or the SEC.

Given these risks and uncertainties, you should not place undue reliance on these forward-looking statements. Also, forward-looking statements represent our management's beliefs and assumptions only as of the date of this Quarterly Report on Form 10-Q. You should read this Quarterly Report on Form 10-Q completely and with the understanding that our actual future results may be materially different from what we expect. We hereby qualify our forward-looking statements by these cautionary statements. Except as required by law, we assume no obligation to update these forward-looking statements publicly, or to update the reasons actual results could differ materially from those anticipated in these forward-looking statements, even if new information becomes available in the future.

The following discussion and analysis of our financial condition and results of operations should be read in conjunction with our interim condensed consolidated financial statements and related notes included elsewhere in this Quarterly Report on Form 10-Q and in our other SEC filings, including the audited consolidated financial statements and the accompanying notes for the fiscal year ended December 31, 2015, which are included in our Annual Report on Form 10-K, filed with the SEC on February 12, 2016.

Overview

We are a leading provider of secure, cloud-based virtual banking solutions. We enable regional and community financial institutions, or RCFIs, to deliver a robust suite of integrated virtual banking services to more effectively engage with their retail and commercial account holders who expect to bank anytime, anywhere and on any device. Our solutions are often the most frequent point of interaction between our RCFI customers and their account holders. As such, we purpose-build our solutions to deliver a compelling, consistent user experience across digital channels and drive the success of our customers by extending their local brands, enabling improved account holder retention and creating incremental sales opportunities.

The effective delivery and management of secure and advanced virtual banking solutions in the complex and heavily-regulated financial services industry requires significant resources, personnel and expertise. We provide virtual banking solutions that are designed to be highly configurable, scalable and adaptable to the specific needs of our RCFI customers. Our solutions deliver to account holders a unified virtual banking experience across online, mobile, voice and tablet channels by leveraging a common platform that integrates our solutions with each other and with our customers' other internal and third-party systems. In addition, we design our solutions and our data center infrastructure to comply with stringent security and technical regulations applicable to financial institutions and to safeguard our customers and their account holders through features such as real-time risk and fraud analytics.

We deliver our solutions to the substantial majority of our customers using a software-as-a-service, or SaaS, model under which our customers pay subscription fees for the use of our solutions. A small portion of our customers host our solutions in their own data centers under term license and maintenance agreements. Our customers have numerous account holders, and those account holders can represent one or more registered users on our solutions. We generally price our solutions based on the number of solutions purchased by our customers and the number of registered users utilizing our solutions. We earn additional revenues based on the number of bill-pay and certain other transactions that registered users perform on our virtual banking solutions in excess of the levels included in our standard subscription fee. As a result, our revenues grow as our customers buy

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more solutions from us and increase the number of registered users utilizing our solutions and as those users increase their number of transactions on our solutions.

We have achieved significant growth since our inception. During each of the past five years, our average number of registered users per installed customer has grown, and we have been able to sell additional solutions to existing customers. Our revenues per installed customer and per registered user vary period-to-period based on the length and timing of customer implementations, changes in the average number of registered users per customer, sales of additional solutions to existing customers, changes in the number of transactions on our solutions by registered users and variations among existing customers and new customers with respect to the mix of purchased solutions and related pricing.

We believe we have a significant opportunity to continue to grow our business, and we intend to invest across our organization to increase our revenues and improve our operating efficiencies. These investments will increase our costs on an absolute dollar basis, but the timing and amount of these investments will vary based on the rate at which we expect to add new customers, the implementation and support needs of our customers, our software development plans, our technology infrastructure requirements and the internal needs of our organization. Many of these investments will occur in advance of our realizing any resultant benefit which may make it difficult to determine if we are effectively allocating our resources.

If we are successful in growing our revenues by increasing the number and scope of our customer relationships, we anticipate that greater economies of scale and increased operating leverage will improve our margins over the long term. We also anticipate that increases in the number of registered users for existing customers will improve our margins. However, we do not have any control or influence over whether account holders elect to become registered users of our customers' virtual banking services.

We sell our solutions primarily through our professional sales organization. Our target market of RCFIs is well-defined as a result of applicable governmental regulations. As a result, we are able to effectively concentrate our sales and marketing efforts on these readily-identifiable financial institutions. We intend to add sales representatives for both banks and credit unions across the U.S. We also expect to increase our number of sales support and marketing personnel, as well as our investment in marketing initiatives designed to increase awareness of our solutions and generate new customer opportunities.

We seek to help our RCFI customers succeed by providing advanced virtual banking solutions that allow our customers to distinguish themselves from competing financial institutions and better engage with their account holders. We believe that we successfully compete in our market due to our deep domain expertise, reputation for innovation and the quality, breadth and integration of our solutions and common platform. We have made significant investments, and intend to increase investments in technology innovation and software development as we enhance our solutions and platform and increase or expand the number of solutions that we offer to RCFIs and their account holders.

We believe that delivery of consistent, high-quality customer support is a significant driver of RCFI purchasing and renewal decisions. To develop and maintain a reputation for high-quality service, we seek to build deep relationships with our customers through our customer service organization, which we staff with personnel who are motivated by our common mission of using technology to help RCFIs succeed and who are knowledgeable with respect to the regulated and complex nature of the financial services industry. As we grow our business, we must continue to invest in and grow our services organization to support our customers' needs and maintain our reputation.

During 2015, we acquired all of the outstanding shares of Centrix Solutions, Inc., or Centrix, a privately owned company that provides financial institutions with products that detect fraud, manage risk and simplify compliance and

acquired all of the outstanding ownership interests of Smarty Pig, LLC, doing business as Social Money, or Social Money, a privately owned financial services software company that offers a modern, cloud-based platform that assists financial institutions in their direct digital strategies.

Key Operating Measures

In addition to the United States generally accepted accounting principles, or GAAP, measures described below in "Management's Discussion and Analysis of Financial Condition and Results of Operations—Components of Operating Results," we monitor the following operating measures to evaluate growth trends, plan investments and measure the effectiveness of our sales and marketing efforts:

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Installed Customers

We define installed customers as the number of customers on the Q2 platform from which we are currently recognizing revenues. The average size of our installed customers, measured in both registered users per installed customer and revenues per installed customer, has increased over time as our existing installed customers continue to add registered users and buy more solutions from us, and as we add larger RCFIs to our installed customer base. The rate at which we add installed customers varies based on our implementation capacity, the size and unique needs of our customers and the readiness of our customers to implement our solutions. We had 369, 361 and 334 installed customers on the Q2 platform as of December 31, 2015, 2014 and 2013, respectively.

Registered Users

We define a registered user as an individual related to an account holder of an installed customer on the Q2 platform who has registered to use one or more of our solutions and has current access to use those solutions as of the last day of the reporting period presented. We price our solutions based on the number of registered users, so as the number of registered users of our solutions increases, our revenues grow. Our average number of registered users per installed customer grows as our existing customers add more registered users and as we add larger RCFIs to our installed customer base. We anticipate that the number of registered users will grow at a faster rate than our number of installed customers. The rate at which our customers add registered users and the incremental revenues we recognize from new registered users vary significantly period-to-period based on the timing of our implementations of new customers and the timing of registration of new users. Our installed customers had approximately 6.3 million, 4.3 million and 3.1 million registered users on the Q2 platform as of December 31, 2015, 2014 and 2013, respectively. Registered users on the Q2 platform at September 30, 2016 were 7.8 million compared to 6.0 million at September 30, 2015.

Revenue Retention Rate

We believe that our ability to retain our installed customers and expand their use of our products and services over time is an indicator of the stability of our revenue base and the long-term value of our customer relationships. We assess our performance in this area using a metric we refer to as our revenue retention rate. We calculate our revenue retention rate as the total revenues in a calendar year from customers who were installed customers as of December 31 of the prior year, expressed as a percentage of the total revenues during the prior year from those installed customers. Our revenue retention rate provides insight into the impact on current year revenues of the number of new customers implemented on the Q2 platform during the prior year, the timing of our implementation of those new customers in the prior year, growth in the number of registered users and changes in their usage of our solutions, sales of new products and services to our existing installed customers during the current year and installed customer attrition. The most significant drivers of changes in our revenue retention rate each year have historically been the number of new customers in the prior year and the timing of our implementation of those new customers. The timing of our implementation of new customers in the prior year is significant because we do not start recognizing revenues from new customers until they become installed customers. If implementations are weighted more heavily in the first or second half of the prior year, our revenue retention rate will be lower or higher, respectively. Our use of revenue retention rate has limitations as an analytical tool, and investors should not consider it in isolation. Other companies in our industry may calculate revenue retention rate differently, which reduces its usefulness as a comparative measure. Our revenue retention rate was 122%, 122% and 128% for the years ended December 31, 2015, 2014 and 2013, respectively.

Churn

We utilize churn to monitor the satisfaction of our clients and evaluate the effectiveness of our business strategies. We define churn as the amount of any monthly recurring revenue losses due to installed customer cancellations and

downgrades, net of upgrades and additions of new solutions, during a year, divided by our monthly recurring revenue at the beginning of the year. Cancellations refer to installed customers that have either stopped using our services completely or remained a customer but terminated a particular service. Downgrades are a result of customers taking less of a particular service or renewing their contract for identical services at a lower price. Our annual churn was 3.5%, 4.8% and 3.5% for the years ended December 31, 2015, 2014 and 2013, respectively. Our use of churn has limitations as an analytical tool, and investors should not consider it in isolation. Other companies in our industry may calculate churn differently, which reduces its usefulness as a comparative measure.

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Adjusted EBITDA

We define adjusted EBITDA as net loss before depreciation, amortization, loss from discontinued operations, stock-based compensation, certain costs related to our recent acquisitions, unoccupied lease charges, provision for income taxes, and total other expense, net. We believe that adjusted EBITDA provides useful information to investors and others in understanding and evaluating our operating results for the following reasons:

adjusted EBITDA is widely used by investors and securities analysts to measure a company's operating performance without regard to items that can vary substantially from company to company depending upon their financing, capital structures and the method by which assets were acquired;

our management uses adjusted EBITDA in conjunction with GAAP financial measures for planning purposes, in the preparation of our annual operating budget, as a measure of our operating performance, to assess the effectiveness of our business strategies and to communicate with our board of directors concerning our financial performance;

adjusted EBITDA provides more consistency and comparability with our past financial performance, facilitates period-to-period comparisons of our operations and also facilitates comparisons with other companies, many of which use similar non-GAAP financial measures to supplement their GAAP results; and

our investor and analyst presentations include adjusted EBITDA as a supplemental measure of our overall operating performance.

Adjusted EBITDA should not be considered as an alternative to net loss or any other measure of financial performance calculated and presented in accordance with GAAP. The use of adjusted EBITDA as an analytical tool has limitations such as:

depreciation and amortization are non-cash charges, and the assets being depreciated or amortized will often have to be replaced in the future and adjusted EBITDA does not reflect cash requirements for such replacements;

adjusted EBITDA may not reflect changes in, or cash requirements for, our working capital needs or contractual commitments;

adjusted EBITDA does not reflect the potentially dilutive impact of stock-based compensation;

adjusted EBITDA does not reflect interest or tax payments that could reduce cash available for use; and

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

Because of these and other limitations, you should consider adjusted EBITDA together with our GAAP financial measures including cash flow from operations and net loss. The following table presents a reconciliation of net loss to adjusted EBITDA for each of the periods indicated (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
Reconciliation of net loss to adjusted EBITDA:				
Net loss	\$(9,481)	\$(7,016)	\$(28,841)	\$(16,643)
Depreciation and amortization	3,064	1,873	8,935	4,429

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Stock-based compensation expense	3,359	1,911	8,821	4,872
Provision for income taxes	97	79	330	123
Interest and other (income) expense, net	64	(13)	135	3
Acquisition related costs	1,835	1,006	4,793	1,006
Unoccupied lease charges	—	—	33	—
Adjusted EBITDA	\$(1,062)	\$(2,160)	\$(5,794)	\$(6,210)

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Components of Operating Results

Revenues

All of our revenue-generating activities directly relate to the sale, implementation and support of our solutions within a single operating segment. We derive the substantial majority of our revenues from subscription fees for the use of our solutions hosted in our data centers as well as revenues for implementation and customer support services related to our solutions. A small portion of our customers host our solutions in their own data centers under term license and maintenance agreements, and we recognize the corresponding revenues over the term of those customer agreements.

Subscription fees are based on the number of solutions purchased by our customers, the number of registered users and the number of bill-pay and certain other transactions those users conduct using our solutions in excess of the levels included in our standard subscription fee. Subscription fees are billed and recognized monthly over the term of our customer agreements. The initial term of our customer agreements averages over five years, although it varies by customer. We begin recognizing subscription fees on the date a solution is implemented and made available to the customer. The timing of our implementations varies period-to-period based on our implementation capacity, the number of solutions purchased by our customers, the size and unique needs of our customers and the readiness of our customers to implement our solutions. We recognize any related implementation services revenues ratably over the initial agreement term beginning on the date we commence recognizing subscription fees. Amounts that have been invoiced but not paid are recorded in accounts receivable and in revenues or deferred revenues, depending on whether our revenue recognition criteria have been met.

We consider subscription fees to be fixed or determinable unless the fees are subject to refund or adjustment or are not payable within our standard payment terms. In determining whether collection of subscription fees is reasonably assured, we consider financial and other information about customers, such as a customer's current credit-worthiness and payment history over time. Historically, our bad debt expenses have not been significant.

Cost of Revenues

Cost of revenues is comprised primarily of salaries and other personnel-related costs, including employee benefits, bonuses and stock-based compensation, for employees providing services to our customers. This includes the costs of our implementation, customer support, data center and customer training personnel. Cost of revenues also includes: the direct costs of bill-pay and other third-party intellectual property included in our solutions; the amortization of deferred solution and services costs; co-location facility costs and depreciation of our data center assets; an allocation of general overhead costs; the amortization of acquired technology; and, referral fees. We allocate general overhead expenses to all departments based on the number of employees in each department, which we consider to be a fair and representative means of allocation.

We capitalize certain personnel costs directly related to the implementation of our solution to the extent those costs are considered to be recoverable from future revenues. We amortize the costs for a particular implementation once revenue recognition commences, and we amortize those implementation costs over the remaining term of the customer agreement. Other costs not directly recoverable from future revenues are expensed in the period incurred.

We capitalize certain software development costs related to programmers, software engineers and quality control teams working on our software solutions. The costs related to software development that are incurred between reaching technological feasibility of a solution and the point at which the solution is ready for general release are capitalized and are included in intangible assets, net on the condensed consolidated balance sheet. As products have not reached general release, we have not commenced amortization on these costs. Amortization of capitalized software development costs will be computed on an individual product basis for those products available for market

and will be recognized based on the product's estimated economic life and these costs will be recognized in cost of revenues.

We intend to continue to increase our investments in our implementation and customer support teams and technology infrastructure to serve our customers and support our growth. We expect cost of revenues to continue to grow in absolute dollars as we grow our business but to fluctuate as a percentage of revenues based principally on the level and timing of implementation and support activities and other related costs.

Operating Expenses

Operating expenses consist of sales and marketing, research and development and general and administrative expenses. We intend to continue to hire new employees and make other investments to support our anticipated growth. As a result, we

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expect our operating expenses to increase in absolute dollars but to decrease as a percentage of revenues over the long term as we grow our business.

Sales and Marketing

Sales and marketing expenses consist primarily of salaries and other personnel-related costs, including commissions, benefits, bonuses and stock-based compensation. Sales and marketing expenses also include expenses related to advertising, lead generation, promotional event programs, corporate communications, travel and allocated overhead.

Sales and marketing expenses as a percentage of total revenues will change in any given period based on several factors including the addition of newly-hired sales professionals, the number and timing of newly-installed customers and the amount of sales commissions expense amortized related to those customers. Commissions are generally capitalized and then amortized over the life of the customer agreement.

Sales and marketing expenses are also impacted by the timing of significant marketing programs such as our annual user conference which we typically hold during the second quarter. We plan to continue investing in sales and marketing by increasing our number of sales and marketing personnel and expanding our sales and marketing activities. We believe these investments will help us build brand awareness, add new customers and expand sales to our existing customers as they continue to buy more solutions from us, the number of registered users utilizing our solutions grows and those users increase the number of transactions on our solutions.

Research and Development

We believe that continuing to improve and enhance our solutions is essential to maintaining our reputation for innovation and growing our customer base and revenues. Research and development expenses include salaries and personnel-related costs, including benefits, bonuses and stock-based compensation, third-party contractor expenses, software development costs, allocated overhead and other related expenses incurred in developing new solutions and enhancing existing solutions. Research and development expenses are expensed as incurred.

Certain research and development costs that are related to our software development, which includes salaries and other personnel-related costs, including employee benefits and bonuses attributed to programmers, software engineers and quality control teams working on our software solutions, are capitalized and are included in intangible assets, net on the condensed consolidated balance sheet.

General and Administrative

General and administrative expenses consist primarily of salaries and other personnel-related costs, including benefits, bonuses and stock-based compensation, of our administrative, finance and accounting, information systems, legal and human resources employees. General and administrative expenses also include consulting and professional fees, insurance and travel. We expect to continue to incur incremental expenses associated with the growth of our business and to meet increased compliance requirements associated with operating as a public company. These expenses include costs to comply with Section 404 of the Sarbanes-Oxley Act and other regulations governing public companies, increased costs of directors' and officers' liability insurance, increased professional services expenses and costs associated with enhanced investor relations activities.

Acquisition Related Costs

Acquisition related costs include compensation expenses related to milestone provisions and retention agreements with certain former shareholders and employees of Centrix and Social Money which are recognized as earned, and

various legal and professional service expenses incurred in connection with the acquisitions, which were recognized when incurred.

Amortization of Acquired Intangibles

Amortization of acquired intangibles represent the amortization of intangibles recorded in connection with our business acquisitions which are amortized on a straight-line basis over the estimated useful lives of the related assets.

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Total Other Income (Expense), Net

Total other income (expense), net, consists primarily of interest income and expense and loss on disposal of long-lived assets. We earn interest income on our cash, cash equivalents and investments. Interest expense consists primarily of the interest incurred on our credit facility with Wells Fargo Bank, National Association, or our Credit Facility, and fees and interest associated with the letter of credit issued through our Credit Facility to our landlord for the security deposit for our corporate headquarters.

Provision for Income Taxes

As a result of our current net operating loss position, current income tax expenses consist primarily of state income taxes, and deferred income tax expenses relate to the tax amortization of recently acquired goodwill, resulting in the recognition of a net deferred tax liability.

Results of Operations

Condensed Consolidated Statements of Operations Data

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
Revenues	\$38,305	\$28,018	\$108,069	\$78,459
Cost of revenues ⁽¹⁾⁽²⁾	19,599	15,135	56,283	42,545
Gross profit	18,706	12,883	51,786	35,914
Operating expenses:				
Sales and marketing ⁽²⁾	8,980	6,660	26,798	19,841
Research and development ⁽²⁾	8,219	5,979	23,952	14,927
General and administrative ⁽²⁾	8,624	5,961	23,482	16,430
Acquisition related costs	1,835	1,006	4,793	1,006
Amortization of acquired intangibles	368	227	1,104	227
Unoccupied lease charges	—	—	33	—
Total operating expenses	28,026	19,833	80,162	52,431
Loss from operations	(9,320)	(6,950)	(28,376)	(16,517)
Total other income (expense), net	(64)	13	(135)	(3)
Loss before income taxes	(9,384)	(6,937)	(28,511)	(16,520)
Provision for income taxes	(97)	(79)	(330)	(123)
Net loss	\$(9,481)	\$(7,016)	\$(28,841)	\$(16,643)

Includes amortization of acquired technology of \$0.8 million and \$0.2 million for the three months ended

⁽¹⁾ September 30, 2016 and 2015, respectively, and \$2.4 million and \$0.2 million for the nine months ended September 30, 2016 and 2015, respectively.

⁽²⁾ Includes stock-based compensation expenses as follows (in thousands):

	Three Months Ended	Nine Months Ended
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	September 30,		September 30,	
	2016	2015	2016	2015
Cost of revenues	\$547	\$290	\$1,408	\$706
Sales and marketing	587	399	1,514	1,035
Research and development	766	302	2,050	681
General and administrative	1,459	920	3,849	2,450
Total stock-based compensation expenses	\$3,359	\$1,911	\$8,821	\$4,872

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The following table sets forth our condensed consolidated statements of operations data as a percentage of revenues for each of the periods indicated:

	Three Months		Nine Months	
	Ended September 30,		Ended September 30,	
	2016	2015	2016	2015
Revenues	100.0 %	100.0 %	100.0 %	100.0 %
Cost of revenues ⁽¹⁾⁽²⁾	51.2	54.0	52.1	54.2
Gross profit	48.8	46.0	47.9	45.8
Operating expenses:				
Sales and marketing ⁽²⁾	23.4	23.8	24.8	25.3
Research and development ⁽²⁾	21.5	21.3	22.2	19.0
General and administrative ⁽²⁾	22.5	21.3	21.7	20.9
Acquisition related costs	4.8	3.6	4.4	1.3
Amortization of acquired intangibles	1.0	0.8	1.0	0.3
Unoccupied lease charges	—	—	0.1	—
Total operating expenses	73.2	70.8	74.2	66.8
Loss from operations	(24.4)	(24.8)	(26.3)	(21.0)
Total other income (expense), net	(0.2)	—	(0.1)	—
Loss before income taxes	(24.6)	(24.8)	(26.4)	(21.0)
Provision for income taxes	(0.3)	(0.3)	(0.3)	(0.2)
Net loss	(24.8)%	(25.0)%	(26.7)%	(21.2)%

(1) Includes amortization of acquired technology of 2.1% and 0.7% for the three months ended September 30, 2016 and 2015, respectively, and 2.2% and 0.3% for the nine months ended September 30, 2016 and 2015, respectively.

(2) Includes stock-based compensation expenses as follows:

	Three		Nine	
	Months		Months	
	Ended		Ended	
	September		September	
	30,	30,	30,	30,
	2016	2015	2016	2015
Cost of revenues	1.4 %	1.0 %	1.3 %	0.9 %
Sales and marketing	1.5	1.4	1.4	1.3
Research and development	2.0	1.1	1.9	0.9
General and administrative	3.8	3.3	3.6	3.1
Total stock-based compensation expenses	8.8 %	6.8 %	8.2 %	6.2 %

Due to rounding, totals may not equal the sum of the line items in the tables above.

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Comparison of Three and Nine Months Ended September 30, 2016 and 2015

Revenues

The following table presents our revenues for each of the periods indicated (dollars in thousands):

	Three Months				Nine Months			
	Ended September 30,		Change		Ended September 30,		Change	
	2016	2015	\$	(%)	2016	2015	\$	(%)
Revenues	\$38,305	\$28,018	\$10,287	36.7%	\$108,069	\$78,459	\$29,610	37.7%

Three Months Ended September 30, 2016 Compared to Three Months Ended September 30, 2015. Revenues increased by \$10.3 million, or 36.7%, from \$28.0 million for the three months ended September 30, 2015 to \$38.3 million for the three months ended September 30, 2016. This increase in revenue was primarily attributable to a \$9.1 million increase from growth in new registered users from existing customers and the addition of registered users from newly installed customers. The remaining \$1.2 million of revenue growth was generated primarily from an increase in the number of transactions processed using our solutions.

Nine Months Ended September 30, 2016 Compared to Nine Months Ended September 30, 2015. Revenues increased by \$29.6 million, or 37.7%, from \$78.5 million for the nine months ended September 30, 2015 to \$108.1 million for the nine months ended September 30, 2016. This increase in revenue was primarily attributable to a \$26.3 million increase from growth in new registered users from existing customers and the addition of registered users from newly installed customers. The remaining \$3.3 million of revenue growth was generated primarily from an increase in the number of transactions processed using our solutions.

Cost of Revenues

The following table presents our cost of revenues for each of the periods indicated (dollars in thousands):

	Three Months Ended				Nine Months Ended			
	September 30,		Change		September 30,		Change	
	2016	2015	\$	(%)	2016	2015	\$	(%)
Cost of revenues	\$19,599	\$15,135	\$4,464	29.5%	\$56,283	\$42,545	\$13,738	32.3%
Percentage of revenues	51.2	% 54.0	%		52.1	% 54.2	%	

Three Months Ended September 30, 2016 Compared to Three Months Ended September 30, 2015. Cost of revenues increased by \$4.5 million, or 29.5%, from \$15.1 million for the three months ended September 30, 2015 to \$19.6 million for the three months ended September 30, 2016. This increase was attributable to a \$1.4 million increase in personnel costs due to an increase in the number of personnel who provide implementation and customer support and maintain our data centers and other technical infrastructure, which included a \$0.3 million increase in stock-based compensation expense allocated to cost of revenue expenses for the increase in the number and value of stock-based awards vesting during the period, a \$1.1 million increase in third-party costs related to intellectual property included in our solutions and transaction processing costs incurred as a result of the increase in registered users from existing and new customers, as well as implementation and support personnel expenses that are reimbursable from our customers, a \$0.7 million increase in co-location facility costs and depreciation for our data center assets resulting from the increased infrastructure necessary to support our growing customer base, a \$0.6 million increase in amortization of acquired customer technology, a \$0.5 million increase in facilities and other overhead costs which were allocated to our implementation and support departments, and a \$0.2 million increase in travel and other discretionary expenses.

Nine Months Ended September 30, 2016 Compared to Nine Months Ended September 30, 2015. Cost of revenues increased by \$13.7 million, or 32.3%, from \$42.5 million for the nine months ended September 30, 2015 to \$56.3 million for the nine months ended September 30, 2016. This increase was attributable to a \$4.1 million increase in personnel costs due to an increase in the number of personnel who provide implementation and customer support and maintain our data centers and other technical infrastructure, which included a \$0.7 million increase in stock-based compensation expense allocated to cost of revenue expenses for the increase in the number and value of stock-based awards vesting during the period, a \$3.4 million increase in third-party costs related to intellectual property included in our solutions and transaction processing costs incurred

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as a result of the increase in registered users from existing and new customers, as well as implementation and support personnel expenses that are reimbursable from our customers, a \$2.3 million increase in co-location facility costs and depreciation for our data center assets resulting from the increased infrastructure necessary to support our growing customer base, a \$2.2 million increase in amortization of acquired customer technology, a \$1.3 million increase in facilities and other overhead costs which were allocated to our implementation and support departments, and a \$0.4 million increase in travel and other discretionary expenses.

We defer certain payroll costs directly related to the implementation of our solutions to the extent those costs are considered to be recoverable from future revenues. However, a substantial portion of our implementation costs are not eligible for deferral and, as a result, are expensed in the period incurred. Costs related to implementations that have been deferred are amortized over the same period in which the related revenue is recognized. Additionally, we invest in personnel, business processes and systems infrastructure to standardize our business processes and drive future efficiency in our implementations, customer support and data center operations. We expect these investments will increase cost of revenues in absolute dollars as we continue to make investments in capacity and process improvement, and we expect future expansion of gross margin as we begin to achieve economies of scale from these investments.

Operating Expenses

The following tables present our operating expenses for each of the periods indicated (dollars in thousands):

Sales and Marketing

	Three Months Ended September 30,		Change \$ (%)	Nine Months Ended September 30,		Change \$ (%)
	2016	2015		2016	2015	
Sales and marketing	\$8,980	\$6,660	\$2,320 34.8%	\$26,798	\$19,841	\$6,957 35.1%
Percentage of revenues	23.4 %	23.8 %		24.8 %	25.3 %	

Three Months Ended September 30, 2016 Compared to Three Months Ended September 30, 2015. Sales and marketing expenses increased by \$2.3 million, or 34.8%, from \$6.7 million for the three months ended September 30, 2015 to \$9.0 million for the three months ended September 30, 2016. This increase was primarily attributable to a \$1.7 million increase in personnel costs due to the growth of our sales and marketing organizations, which included a \$0.2 million increase in stock-based compensation expense allocated to sales and marketing expenses for the increase in the number and value of stock-based awards vesting during the period, a \$0.3 million increase in travel and other discretionary marketing spend, and a \$0.3 million increase in facilities and other overhead costs which were allocated to our sales and marketing departments.

Nine Months Ended September 30, 2016 Compared to Nine Months Ended September 30, 2015. Sales and marketing expenses increased by \$7.0 million, or 35.1%, from \$19.8 million for the nine months ended September 30, 2015 to \$26.8 million for the nine months ended September 30, 2016. This increase was primarily attributable to a \$5.2 million increase in personnel costs due to the growth of our sales and marketing organizations, which included a \$0.5 million increase in stock-based compensation expense allocated to sales and marketing expenses for the increase in the number and value of stock-based awards vesting during the period, a \$0.9 million increase in facilities and other overhead costs which were allocated to our sales and marketing departments, a \$0.5 million increase in recruiting and travel related expenses, and a \$0.4 million increase in discretionary marketing spend.

We anticipate that sales and marketing expenses will continue to increase in absolute dollars in the future as we add personnel to support our revenue growth and as we increase discretionary marketing spending to attract new

customers, retain and grow existing customers and drive brand awareness. We expect such expenses to decline as a percentage of our revenues over time as our revenues grow.

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Research and Development

	Three Months Ended September 30,				Nine Months Ended September 30,			
	2016	2015	\$	(%)	2016	2015	\$	(%)
Research and development	\$8,219	\$5,979	\$2,240	37.5%	\$23,952	\$14,927	\$9,025	60.5%
Percentage of revenues	21.5	% 21.3	%		22.2	% 19.0	%	

Three Months Ended September 30, 2016 Compared to Three Months Ended September 30, 2015. Research and development expenses increased by \$2.2 million, or 37.5%, from \$6.0 million for the three months ended September 30, 2015 to \$8.2 million for the three months ended September 30, 2016. This increase was primarily attributable to a \$1.8 million increase in personnel costs as a result of the growth in our research and development organization to support continued enhancements to our solutions, which included a \$0.4 million increase in stock-based compensation expense allocated to research and development expenses for the increase in the number and value of stock-based awards vesting during the period, and a \$0.5 million increase in facilities and other overhead costs which were allocated to our research and development departments, partially offset by a \$0.1 million decrease in recruiting expenses.

Nine Months Ended September 30, 2016 Compared to Nine Months Ended September 30, 2015. Research and development expenses increased by \$9.0 million, or 60.5%, from \$14.9 million for the nine months ended September 30, 2015 to \$24.0 million for the nine months ended September 30, 2016. This increase was primarily attributable to a \$7.4 million increase in personnel costs as a result of the growth in our research and development organization to support continued enhancements to our solutions, which included a \$1.4 million increase in stock-based compensation expense allocated to research and development expenses for the increase in the number and value of stock-based awards vesting during the period, a \$1.5 million increase in facilities and other overhead costs which were allocated to our research and development departments, and a \$0.3 million increase in travel and other discretionary expenses, partially offset by a \$0.2 million decrease in recruiting expenses.

We anticipate that research and development expenses will increase in absolute dollars in the future as we continue to support and expand our platform and enhance our existing solutions.

General and Administrative

	Three Months Ended September 30,				Nine Months Ended September 30,			
	2016	2015	\$	(%)	2016	2015	\$	(%)
General and administrative	\$8,624	\$5,961	\$2,663	44.7%	\$23,482	\$16,430	\$7,052	42.9%
Percentage of revenues	22.5	% 21.3	%		21.7	% 20.9	%	

Three Months Ended September 30, 2016 Compared to Three Months Ended September 30, 2015. General and administrative expenses increased by \$2.7 million, or 44.7%, from \$6.0 million for the three months ended September 30, 2015 to \$8.6 million for the three months ended September 30, 2016. The increase in general and administrative expenses was primarily attributable to a \$1.5 million increase in personnel costs to support the growth of our business, which included a \$0.5 million increase in stock-based compensation expense allocated to general and administrative expenses for the increase in the number and value of stock-based awards vesting during the period, a \$0.8 million increase in professional services due to the increased costs associated with being a public company, and a \$0.4 million increase in facilities and other overhead costs which were allocated to our general and administrative departments.

Nine Months Ended September 30, 2016 Compared to Nine Months Ended September 30, 2015. General and administrative expenses increased by \$7.1 million, or 42.9%, from \$16.4 million for the nine months ended September 30, 2015 to \$23.5 million for the nine months ended September 30, 2016. The increase in general and administrative expenses was primarily attributable to a \$3.8 million increase in personnel costs to support the growth of our business, which included a \$1.4 million increase in stock-based compensation expense allocated to general and administrative expenses for the increase in the number and value of stock-based awards vesting during the period, a \$2.1 million increase in professional services due to the

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increased costs associated with being a public company, and a \$1.1 million increase in facilities and other overhead costs which were allocated to our general and administrative departments.

General and administrative expenses include costs to comply with Section 404 of the Sarbanes-Oxley Act, or SOX, and other regulations governing public companies, costs of directors' and officers' liability insurance, and professional services expenses and costs associated with investor relations activities as a result of being a public company. As of June 30, 2016, the market value of our common stock held by non-affiliates exceeded \$700 million. Commencing January 1, 2017, we will be deemed a large accelerated filer and, accordingly, will no longer qualify as an emerging growth company and will no longer be able to rely on certain exemptions that were previously available to us as an emerging growth company. We anticipate that general and administrative expenses will remain elevated in the fourth quarter of 2016 as we incur both increased external audit fees as well as accelerated spending to ensure SOX compliance given this change in filing status.

Acquisition Related Costs

	Three Months				Nine Months			
	Ended September 30, 2016		Change		Ended September 30, 2016		Change	
	2016	2015	\$	(%)	2016	2015	\$	(%)
Acquisition related costs	\$1,835	\$1,006	\$829	82.4%	\$4,793	\$1,006	\$3,787	376.4%
Percentage of revenues	4.8	% 3.6	%		4.4	% 1.3	%	

Three Months Ended September 30, 2016 Compared to Three Months Ended September 30, 2015. Acquisition related costs increased by \$0.8 million, or 82.4%, from \$1.0 million for the three months ended September 30, 2015 to \$1.8 million for the three months ended September 30, 2016. These expenses are related to our purchase of Centrix in the third quarter of 2015 and Social Money in the fourth quarter of 2015. The expense for the three months ended September 30, 2016 is comprised solely of compensation expense related to the achievement of milestone and retention bonuses for employees of Centrix and Social Money. The expense for the three months ended September 30, 2015 included \$0.8 million of compensation related to milestone and retention bonuses for employees of Centrix and \$0.2 million of legal and other expenses incurred related to the acquisitions.

Nine Months Ended September 30, 2016 Compared to Nine Months Ended September 30, 2015. Acquisition related costs increased by \$3.8 million, or 376.4%, from \$1.0 million for the nine months ended September 30, 2015 to \$4.8 million for the nine months ended September 30, 2016. These expenses are related to our purchase of Centrix in the third quarter of 2015 and Social Money in the fourth quarter of 2015. The expense for the nine months ended September 30, 2016 is comprised primarily of compensation expense related to the achievement of milestone and retention bonuses for employees of Centrix and Social Money along with \$0.2 million of legal and other expenses incurred related to the acquisition of Social Money. The expense for the nine months ended September 30, 2015 included \$0.8 million of compensation related to milestone and retention bonuses for employees of Centrix and \$0.2 million of legal and other expenses incurred related to the acquisitions.

Amortization of Acquired Intangibles

	Three Months				Nine Months			
	Ended September 30, 2016		Change		Ended September 30, 2016		Change	
	2016	2015	\$	(%)	2016	2015	\$	(%)
Amortization of acquired intangibles	\$368	\$227	\$141	62.1%	\$1,104	\$227	\$877	386.3%
Percentage of revenues	1.0	% 0.8	%		1.0	% 0.3	%	

Three Months Ended September 30, 2016 Compared to Three Months Ended September 30, 2015. Amortization of acquired intangibles increased \$0.1 million, or 62.1%, from \$0.2 million for the three months ended September 30, 2015 to \$0.4 million for the three months ended September 30, 2016 due to the Centrix and Social Money acquisitions completed in July and November of 2015. respectively.

Nine Months Ended September 30, 2016 Compared to Nine Months Ended September 30, 2015. Amortization of acquired intangibles increased by \$0.9 million, or 386.3%, from \$0.2 million for the nine months ended September 30, 2015 to \$1.1

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million for the nine months ended September 30, 2016 due to the Centrix and Social Money acquisitions completed in July and November of 2015, respectively.

Seasonality and Quarterly Results

Our overall operating results fluctuate from quarter to quarter as a result of a variety of factors, including the timing of investments in growing our business. The timing of our implementation activities and corresponding revenues from new customers are subject to fluctuation based on the timing of our sales. Sales may tend to be lower in the first quarter of each year than in subsequent quarters but any resulting impact on our results of operation has been difficult to measure due to the timing of our implementations and overall growth in our business. The timing of our implementations also varies period-to-period based on our implementation capacity, the number of solutions purchased by our customers, the size and unique needs of our customers and the readiness of our customers to implement our solutions. Our solutions are often the most frequent point of interaction between our customers and their account holders. As a result, we and our customers are very deliberate and careful in our implementation activities to help ensure a successful roll-out of the solutions to account holders and increase the registration of new users. Unusually long or short implementations, for even a small number of customers, may result in short-term quarterly variability in our results of operations.

Our quarterly results of operations may vary significantly in the future, and period-to-period comparisons of our operating results may not be meaningful and should not be relied upon as an indication of future results.

Liquidity and Capital Resources**Sources of Liquidity**

We have financed our operations primarily through the proceeds from the issuance of common stock in our initial public offering, or IPO, and follow-on offerings and cash flows from operations. At September 30, 2016, our principal sources of liquidity were cash, cash equivalents and investments of \$92.3 million and \$22.0 million of available borrowings under our Credit Facility.

Cash Flows

The following table summarizes our cash flows for the periods indicated (in thousands):

	Nine Months Ended September 30,	
	2016	2015
Net cash (used in) provided by:		
Operating activities	\$(1,389)	\$378
Investing activities	(13,217)	(46,639)
Financing activities	(820)	53,451
Net (decrease) increase in cash and cash equivalents	\$(15,426)	\$7,190

Cash Flows from Operating Activities

Cash (used in) provided by operating activities is primarily influenced by the amount and timing of customer receipts and vendor payments and by the amount of cash we invest in personnel and infrastructure to support the anticipated growth of our business and increase in the number of installed customers.

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For the nine months ended September 30, 2016, our net cash and cash equivalents used in operating activities were \$1.4 million, which consisted of a net loss of \$28.8 million, partially offset by cash inflows from changes in operating assets and liabilities of \$4.0 million and non-cash adjustments of \$23.5 million. Cash inflows were the result of a \$12.3 million increase in deferred revenues due to increased payments and deposits received from customers prior to the recognition of revenue from those related payments, a \$9.2 million increase in accounts payable and accrued liabilities due to the timing of payments in support of our expanding customer base and related growth in our technical infrastructure and expanded facilities, and a \$3.3 million increase in deferred rent and other long-term liabilities as a result of the tenant improvement allowances for our new buildings. Cash outflows were the result of an \$11.4 million increase in deferred solution and implementation costs due to our increased customer growth and new and existing customers undergoing implementations during the period, a \$7.3 million increase in accounts receivable due to the timing of billings and customer payments, and a \$2.1 million increase in prepaid and other current assets related to various prepaid expenses. Non-cash items consisted primarily of \$8.9 million of depreciation and amortization expense due to growth in our fixed assets and acquired intangible assets, \$8.8 million of stock-based compensation expense, \$4.9 million of amortization of deferred implementation, deferred solution and other costs, and \$0.8 million of other non-cash items.

For the nine months ended September 30, 2015, our net cash and cash equivalents provided by operating activities were \$0.4 million, which consisted of a net loss of \$16.6 million, partially offset by cash inflows from changes in operating assets and liabilities of \$3.6 million and non-cash adjustments of \$13.4 million. Cash inflows were the result of an \$11.7 million increase in deferred revenues due to increased payments and deposits received from customers prior to the recognition of revenue from those related payments, a \$2.7 million increase in accounts payable and accrued liabilities due to the timing of payments for various third-party direct costs and in support of our expanding customer base, and a \$0.3 million decrease in prepaid and other current assets related to the expensing of various prepaid corporate insurances and other prepaid expenses. Cash outflows were the result of a \$7.7 million increase in deferred solution and implementation costs due to our increased customer growth, new and existing customers undergoing implementations during the period, and due to the timing of annual third-party maintenance billings, and a \$3.4 million increase in accounts receivable due to the timing of billings and customer payments. Non-cash items consisted primarily of \$4.9 million of stock-based compensation expense, \$4.4 million of depreciation and amortization expense due to growth in our fixed assets and acquired intangible assets, and \$3.8 million of amortization of deferred implementation and deferred solution and other costs.

Cash Flows from Investing Activities

Our investing activities have consisted primarily of purchases and maturities of investments, our recent acquisitions, purchases of property and equipment to support our growth, and costs incurred for the development of capitalized software. Purchases of property and equipment may vary period-to-period due to the timing of the expansion of our operations, data center and other technical infrastructure.

For the nine months ended September 30, 2016, net cash used in investing activities was \$13.2 million, consisting primarily of \$32.0 million for the purchase of investments, \$13.6 million for the purchase of property and equipment, \$1.9 million from the capitalization of software development costs, and \$0.3 million from the purchase of other intangible assets, partially offset by \$34.7 million from maturities of investments.

For the nine months ended September 30, 2015, net cash used in investing activities was \$46.6 million, consisting primarily of \$41.4 million for the purchase of investments, \$18.6 million used for the acquisition of Centrix, net of cash acquired, \$3.6 million for the purchase of property and equipment, and a \$0.5 million increase in restricted cash held by the landlord of the Company's new office space, partially offset by \$17.4 million in maturities of investments.

Cash Flows from Financing Activities

Our financing activities have consisted primarily of net proceeds from the issuance of common stock in our follow-on offerings and from exercises of options to purchase common stock offset by payments on financing obligations.

For the nine months ended September 30, 2016, net cash used in financing activities was \$0.8 million, consisting of \$4.9 million of payments on financing obligations and \$0.2 million of payments on capital lease obligations, partially offset by \$4.2 million received from the exercise of stock options.

For the nine months ended September 30, 2015, net cash provided by financing activities was \$53.5 million, consisting primarily of proceeds from the completion of our follow-on offerings, which were completed on March 4, 2015 and September

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30, 2015. We received \$53.0 million in net proceeds from our follow-on offerings after deducting the payment of underwriters' discounts and commissions and offering costs. In addition, during this period, we received \$3.6 million from the exercise of stock options, which was partially offset by \$2.9 million of payments on financing obligations and \$0.3 million of payments on capital lease obligations.

Contractual Obligations and Commitments

During the nine months ended September 30, 2016, and subsequent to September 30, 2016, except as noted below, there were no material changes to our contractual obligations and commitments disclosures as set forth under the caption, "Contractual Obligations and Commitments" in the Management's Discussion and Analysis of Financial Condition and Results of Operations, as reported in our Annual Report on Form 10-K, filed with the SEC on February 12, 2016.

On February 8, 2016, we entered into an office lease agreement to lease approximately 21 thousand rentable square feet in south Austin, Texas. The lease commenced on May 1, 2016, and the term of the lease runs 84 months, with a five-year renewal option, and the rent obligations under the lease begin with rents of \$43,000 per month, which escalate over the course of the lease to \$52,000 per month in the final months of the lease term.

The following table summarizes our contractual obligations and commitments at September 30, 2016 (in thousands):

	Payment due by period				Total
	Less Than 1 Year	1 to 3 Years	3 to 5 Years	More Than 5 Years	
Interest payments - line of credit	\$18	\$—	\$—	\$—	\$18
Operating lease obligations	5,319	11,056	10,584	25,802	52,761
Purchase commitments	8,087	13,908	6,795	—	28,790
Acquisition hold back	2,500	—	—	—	2,500
	\$15,924	\$24,964	\$17,379	\$25,802	\$84,069

Off-Balance Sheet Arrangements

As of September 30, 2016, we did not have any off-balance sheet arrangements, as defined in Item 303(a)(4)(ii) of SEC Regulation S-K, such as the use of unconsolidated subsidiaries, structured finance, special purpose entities or variable interest entities.

Recent Accounting Pronouncements

In May 2014, the Financial Accounting Standards Board, or FASB, issued Accounting Standards Update, or ASU, No. 2014-09, "Revenue from Contracts with Customers (Topic 606)," or ASU 2014-09, which amends the existing accounting standards for revenue recognition. ASU 2014-09 is based on principles that govern the recognition of revenue at an amount an entity expects to be entitled to when products are transferred to customers. In August 2015, the FASB issued ASU No. 2015-14, "Revenue from Contracts with Customers (Topic 606): Deferral of the Effective Date," or ASU 2015-14, that deferred the effective date by one year to December 15, 2017 for interim and annual reporting periods beginning after that date. The FASB permitted early adoption of the standard, but not before the original effective date of December 15, 2016. ASU 2015-14 will be effective for the Company beginning in its first quarter of 2018. Early adoption is permitted beginning in 2017. The new revenue standard may be applied retrospectively to each prior period presented or prospectively with the cumulative effect recognized as of the date of adoption. We are currently evaluating how the adoption of this standard will impact our condensed consolidated financial statements.

In April 2015, the FASB issued ASU No. 2015-03, "Interest - Imputation of Interest (Subtopic 835-30)," or ASU 2015-03, which seeks to simplify the presentation of debt issuance costs. ASU 2015-03 requires that debt issuance costs be classified as a contra-liability against any outstanding borrowings related to such debt issuance costs, rather than as a separate asset. In August 2015, the FASB issued ASU No. 2015-15, "Interest - Imputation of Interest (Subtopic 835-30)," to update ASU 2015-03 and apply accounting guidance to line-of-credit arrangements. We adopted this standard as of March 31, 2016, and its adoption did not have any impact to the condensed consolidated financial statements.

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In April 2015, the FASB issued ASU No. 2015-05, "Intangibles - Goodwill and Other - Internal-Use Software (Subtopic 350-40)," related to accounting for fees paid in a cloud computing arrangement. The new standard provides guidance to customers about whether a cloud computing arrangement includes a software license. If a cloud computing arrangement includes a software license, then the customer should account for the software license element of the arrangement consistent with the acquisition of other software licenses. If a cloud computing arrangement does not include a software license, the customer should account for the arrangement as a service contract. We adopted this standard as of March 31, 2016, and its adoption did not have any impact to the condensed consolidated financial statements.

In September 2015, the FASB issued ASU No. 2015-16, "Business Combinations (Topic 805): Simplifying the Accounting for Measurement-Period Adjustments." The amendments in this update require that an acquirer recognize adjustments to provisional amounts that are identified during the measurement period with a corresponding adjustment to goodwill in the reporting period in which the adjustment amounts are determined. The effect on earnings from changes in depreciation, amortization or other income effects, if any, as a result of the change to the provisional amounts will be recorded in the same period's financial statements, calculated as if the accounting had been completed at the acquisition date. We adopted this standard as of March 31, 2016, and its adoption did not have any impact to the condensed consolidated financial statements.

In February 2016, the FASB issued ASU No. 2016-02, "Leases (Topic 842)," to increase transparency and comparability among organizations by recognizing lease assets and lease liabilities on the balance sheet and disclosing key information about leasing arrangements. The standard is effective for public entities for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years, and early application is permitted. We are currently evaluating how the adoption of this standard will impact our condensed consolidated financial statements.

In March 2016, the FASB issued ASU No. 2016-09, "Improvements to Employee Share-Based Payment Accounting," or ASU 2016-09, which amends Accounting Standards Codification ("ASC") Topic 718, "Compensation – Stock Compensation." ASU 2016-09 simplifies several aspects of the accounting for share-based payment transactions, including the income tax consequences, classification of awards as either equity or liabilities, and classification on the statement of cash flows. The standard is effective for fiscal years beginning after December 15, 2016, and interim periods within those fiscal years and early adoption is permitted. We are currently evaluating how the adoption of this standard will impact our condensed consolidated financial statements.

In August 2016, the FASB issued ASU No. 2016-15, "Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments," to clarify and provide specific guidance on eight cash flow classification issues that are not addressed by current GAAP and thereby reduce the current diversity in practice. The standard is effective for fiscal years beginning after December 15, 2017, and interim periods within those fiscal years and early adoption is permitted. We are currently evaluating how the adoption of this standard will impact our condensed consolidated financial statements.

Critical Accounting Policies and Estimates

The preparation of our interim unaudited condensed consolidated financial statements in accordance with GAAP requires estimates, judgments and assumptions that affect the reported amounts and classifications of assets and liabilities, revenues and expenses and the related disclosures of contingent liabilities in our interim unaudited condensed consolidated financial statements and accompanying notes. The SEC has defined a company's critical accounting policies as the ones that are most important to the portrayal of the company's financial condition and results of operations, and which require the company to make its most difficult and subjective judgments, often as a result of the need to make estimates of matters that are inherently uncertain. Based on this definition, we have

identified the following critical accounting policies and estimates:

- Revenue recognition;
- Deferred revenues;
- Deferred implementation costs;
- Deferred solution and other costs;
- Accounts receivable, net;
- Stock-based compensation;
- Purchase price allocation, intangible assets and goodwill;
 - Capitalization of software development costs; and
- Income taxes.

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We have other key accounting policies, which involve the use of estimates, judgments and assumptions that are significant to understanding our results. See Note 2 Summary of Significant Accounting Policies to the interim unaudited condensed consolidated financial statements included in this Quarterly Report on Form 10-Q. Of those policies, we believe that the accounting policies enumerated above involve the greatest degree of complexity and exercise of judgment by our management.

There were no other significant changes in our critical accounting policies or estimates which were included in the consolidated financial statements and the accompanying notes for the fiscal year ended December 31, 2015, which are included in our Annual Report on Form 10-K, filed with the SEC on February 12, 2016.

We evaluate our estimates, judgments and assumptions on an ongoing basis, and while we believe that our estimates, judgments and assumptions are reasonable, they are based upon information available at the time. Actual results may differ significantly from these estimates under different assumptions, judgments or conditions.

JOBS Act

We have historically filed as an "emerging growth company," as defined in the Jumpstart Our Business Startups Act of 2012, or JOBS Act, which contains provisions that, among other things, reduce certain reporting requirements for qualifying public companies. As defined in the JOBS Act, a public company whose initial public offering of common equity securities occurred after December 8, 2011 and whose annual gross revenues are less than \$1.0 billion will, in general, qualify as an "emerging growth company" until the earliest of:

- the last day of its fiscal year following the fifth anniversary of the date of its initial public offering of common equity securities;

- the last day of its fiscal year in which it has annual gross revenue of \$1.0 billion or more;

- the date on which it has, during the previous three-year period, issued more than \$1.0 billion in non-convertible debt;
- and

- the date on which it is deemed to be a "large accelerated filer," which will occur at such time as the company (a) has an aggregate worldwide market value of common equity securities held by non-affiliates of \$700 million or more as of the last business day of its most recently completed second fiscal quarter, (b) has been required to file annual and quarterly reports under the Exchange Act for a period of at least 12 months and (c) has filed at least one annual report pursuant to the Exchange Act.

Under this definition, we are currently an "emerging growth company" and will remain one until December 31, 2016. As of June 30, 2016, the market value of our common stock held by non-affiliates exceeded \$700 million.

Commencing January 1, 2017, we will be deemed a large accelerated filer and, accordingly, will no longer qualify as an emerging growth company. Our Annual Report on Form 10-K for the year ended December 31, 2016 will reflect this change.

As an "emerging growth company" we have chosen to rely on such exemptions and are therefore not required to, among other things, (i) provide an auditor's attestation report on our system of internal controls over financial reporting pursuant to Section 404 of the Sarbanes-Oxley Act, (ii) provide all of the compensation disclosure that may be required of non-emerging growth public companies under the Dodd-Frank Wall Street Reform and Consumer Protection Act, (iii) comply with any requirement that may be adopted by the Public Company Accounting Oversight Board regarding mandatory audit firm rotation or a supplement to the auditor's report providing additional information about the audit and the financial statements (auditor discussion and analysis) and (iv) disclose certain executive compensation-related items such as the correlation between executive compensation and performance and comparisons of the Chief Executive Officer's compensation to median employee compensation.

In addition, Section 107 of the JOBS Act also provides that an emerging growth company can take advantage of the extended transition period provided in Section 7(a)(2)(B) of the Securities Act for complying with new or revised accounting standards. In other words, an emerging growth company can delay the adoption of certain accounting

standards until those standards would otherwise apply to private companies. However, we have chosen to "opt out" of such extended transition period, and as a result, we will comply with new or revised accounting standards on the relevant dates on which adoption of such standards is required for non-emerging growth companies. Section 107 of the JOBS Act provides that our decision to opt out of the extended transition period for complying with new or revised accounting standards is irrevocable.

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Item 3. Quantitative and Qualitative Disclosures About Market Risk.

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

Interest Rate Risk

We are exposed to market risk related to changes in interest rates. Borrowings under our Credit Facility bear interest at rates that are variable. Increases in the LIBOR or prime rate would increase the amount of interest payable on outstanding borrowings on our Credit Facility. For the three months ended September 30, 2016, a 10% change in either the LIBOR or prime rate would not have had a material impact on our interest expense or cash flows. We do not believe that an increase or decrease in interest rates of 100-basis points would have a material effect on our operating results or financial condition.

Foreign Currency Risk

Our results of operations and cash flows are not subject to fluctuations due to changes in foreign currency exchange rates. We bill our customers in U.S. dollars and receive payment in U.S. dollars, and substantially all of our operating expenses are denominated in U.S. dollars. If we grow sales of our solutions outside the U.S., our agreements with foreign customers may not be denominated in U.S. dollars, and we may become subject to changes in currency exchange rates.

Inflation Risk

We do not believe that inflation has had a material effect on our business, financial condition or results of operations. We continue to monitor the impact of inflation in order to reduce its effects through pricing strategies, productivity improvements and cost reductions. If our costs were to become subject to significant inflationary pressures, we may not be able to fully offset such higher costs through price increases. Our inability or failure to do so could harm our business, financial condition and results of operations.

Item 4. Controls and Procedures.

Evaluation of Disclosure Controls and Procedures

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

Our management, with the participation of our Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of our disclosure controls and procedures as of September 30, 2016, the end of the period covered by this Quarterly Report on Form 10-Q. Based upon such evaluation, our Chief Executive Officer and Chief Financial Officer have concluded that our disclosure controls and procedures were effective as of such date.

Changes in Internal Control over Financial Reporting

There were no changes in our internal control over financial reporting during the three month period covered by this Quarterly Report on Form 10-Q, which were identified in connection with management's evaluation required by Rules 13a-15(d) and 15d-15(d) under the Exchange Act, that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

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PART II - OTHER INFORMATION

Item 1. Legal Proceedings.

From time to time, we may become involved in legal proceedings arising in the ordinary course of our business. Management believes that there are no claims or actions pending against us, the ultimate disposition of which would have a material impact on our business, financial condition, results of operations or cash flows.

Item 1A. Risk Factors.

Reference is made to the factors set forth under the caption "Special Note Regarding Forward-Looking Statements" in Part I, Item 2 of this Quarterly Report on Form 10-Q and other risk factors described in Part I, Item 1A of our Annual Report on Form 10-K for the fiscal year ended December 31, 2015, which are incorporated herein by reference. Except for the following additional risk factor, there have been no material changes from the risk factors disclosed in our Annual Report on Form 10-K for the fiscal year ended December 31, 2015.

Commencing January 1, 2017, we will no longer be an "emerging growth company," and the reduced disclosure requirements applicable to emerging growth companies will no longer apply to us. Our Annual Report on Form 10-K for the year ended December 31, 2016 will reflect this change.

We are currently an "emerging growth company," as defined in the Jumpstart Our Business Startups Act of 2012. Because the market value of our common stock held by non-affiliates exceeded \$700 million as of June 30, 2016, commencing January 1, 2017 we will be deemed a large accelerated filer and, accordingly, will no longer qualify as an emerging growth company. As a large accelerated filer, we will be subject to certain disclosure requirements that apply to other public companies but have not previously applied to us due to our status as an emerging growth company. These requirements include:

• compliance with the auditor attestation requirements in the assessment of our internal control over financial reporting;

• compliance with any requirement that may be adopted by the Public Company Accounting Oversight Board regarding mandatory audit firm rotation or a supplement to the auditor's report providing additional information about the audit and the financial statements;

• full disclosure obligations regarding executive compensation; and

• compliance with the requirements of holding a nonbinding advisory vote on executive compensation and stockholder approval of any golden parachute payments not previously approved.

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

(a) Sales of Unregistered Securities

None.

(b) Use of Proceeds

On March 25, 2014, we completed our IPO of 7,760,870 shares of common stock, at a price of \$13.00 per share, before underwriting discounts and commissions, and on April 2, 2014 we completed the sale of an additional 1,164,131 shares of our common stock, at a price of \$13.00 per share, before underwriting discounts and commissions, as a result of the underwriters' exercise of their over-allotment option to purchase additional shares. We sold 7,414,131 of such shares and existing stockholders sold an aggregate of 1,510,870 of such shares. We did not receive any proceeds from the sale of shares by the selling stockholders in the IPO. The offer and sale of all of the shares in the IPO were registered under the Securities Act pursuant to a registration statement on Form S-1 (File No. 333-193911), which was declared effective by the SEC on March 19, 2014.

There have been no material changes in the planned use of proceeds from our IPO from that described in the final prospectus filed with the SEC pursuant to Rule 424(b) on March 20, 2014. With a portion of the proceeds of the IPO, we repaid approximately \$6.2 million of our outstanding indebtedness under our Credit Facility, completed the acquisition of Centrix for total consideration of \$21.0 million in cash (which included an escrow amount of \$2.0 million), and completed the acquisition of Social Money for \$10.7 million in cash, which includes a hold-back of \$2.5 million payable 18 months after closing date less the portion of any indemnifiable claims, if any. The right of the former shareholders of Centrix to receive in the aggregate up to

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an additional \$9 million based upon the achievement of certain milestones and the continued employment of certain shareholders will also be funded through the use of a portion of the proceeds of the IPO.

On March 4, 2015, we completed a follow-on offering of 5,890,705 shares of our common stock at a price of \$19.75 per share, before underwriting discounts and commissions, including 768,352 shares of our common stock resulting from the underwriters' exercise of their over-allotment option. We sold 1,757,290 of such shares and existing stockholders sold an aggregate of 4,133,415 of such shares. We did not receive any proceeds from the sale of shares by the selling stockholders in the March follow-on offering. The offer and sale of all of the shares in the March follow-on offering were registered under the Securities Act pursuant to a registration statement on Form S-1 (File No. 333-202109), which was declared effective by the SEC on February 26, 2015. There have been no material changes in the planned use of proceeds from the March follow-on offering from that described in the final prospectus filed with the SEC pursuant to Rule 424(b) on February 27, 2015.

On September 30, 2015, we completed a follow-on offering of 3,798,996 shares of our common stock at a price of \$25.50 per share, before underwriting discounts and commissions, and on October 15, 2015 we completed the sale of an additional 569,850 shares of our common stock, at a price of \$25.50 per share, before underwriting discounts and commissions, as a result of the underwriters' exercise of their over-allotment option to purchase additional shares. We sold 853,409 of such shares and existing stockholders sold an aggregate of 3,515,437 of such shares. We did not receive any proceeds from the sale of shares by the selling stockholders in this follow-on offering or as a result of the underwriters exercising their over-allotment option in this offering. The offer and sale of all of the shares in the September follow-on offering were registered under the Securities Act pursuant to a registration statement on Form S-3 (File No. 333-206869), which was declared effective by the SEC on September 24, 2015. There have been no material changes in the planned use of proceeds from our September follow-on offering from that described in the final prospectus filed with the SEC pursuant to Rule 424(b) on September 25, 2015.

(c) Repurchases

Issuer Purchases of Equity Securities

	Total Number of Shares Purchased ⁽¹⁾	Average Price Paid Per Share ⁽²⁾	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Approximate Dollar Value of Shares That May Be Purchased Under the Plans or Programs	
July 1 - 31, 2016	—	\$ —	\$	—\$	—
August 1 - 31, 2016	2,360	26.98	—	—	
September 1 - 30, 2016	—	—	—	—	
Total	2,360	\$ 26.98	\$	—\$	—

(1) Total shares purchased are attributable to shares of common stock tendered to us by one or more holders of common stock options to cover the exercise price of options exercised.

(2) Reflects the closing price of Q2 shares as reported on the New York Stock Exchange on the date of exercise.

Item 3. Defaults Upon Senior Securities.

None.

Item 4. Mine Safety Disclosures.

Not applicable.

Item 5. Other Information.

None.

Item 6. Exhibits.

The information required by this Item is set forth on the exhibit index that follows the signature page of this Quarterly Report on Form 10-Q.

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SIGNATURES

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

Q2 HOLDINGS, INC.

/s/ MATTHEW P. FLAKE

November 3, 2016 By: Matthew P. Flake
Chief Executive Officer
(Principal Executive Officer)

/s/ JENNIFER N. HARRIS

November 3, 2016 By: Jennifer N. Harris
Chief Financial Officer
(Principal Financial and Accounting Officer)

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INDEX TO EXHIBITS

Exhibit Number	Description of Document
3.1	* Fourth Amended and Restated Certificate of Incorporation of the Registrant (filed as Exhibit 3.2 of the Registrant's Form S-1 Registration Statement (Registration No. 333-193911)).
3.2	* Amended and Restated Bylaws of the Registrant (filed as Exhibit 3.4 of the Registrant's Form S-1 Registration Statement (Registration No. 333-193911)).
10.1	* Employment Agreement, dated effective August 22, 2016, by and between Q2 Software, Inc. and Odus Edward Wittenburg, Jr. (filed as Exhibit 10.1 to the Registrant's Current Report on Form 8-K filed with the Securities and Exchange Commission on August 15, 2016).
31.1	** Certification of Chief Executive Officer pursuant to Exchange Act Rule, 13a-14(a) and 15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	** Certification of Chief Financial Officer pursuant to Exchange Act Rule, 13a-14(a) and 15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	# Certification pursuant to 18 U.S.C. 1350, adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, by Chief Executive Officer.
32.2	# Certification pursuant to 18 U.S.C. 1350, adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, by Chief Financial Officer.
101.INS	** XBRL Instance Document.
101.SCH	** XBRL Taxonomy Extension Schema Document.
101.CAL	** XBRL Taxonomy Extension Calculation Linkbase Document.
101.DEF	** XBRL Taxonomy Extension Definition Linkbase Document.
101.LAB	** XBRL Taxonomy Extension Label Linkbase Document.
101.PRE	** XBRL Taxonomy Extension Presentation Linkbase Document.
	* Incorporated herein by reference to the indicated filing.
	** Filed herewith.
	# Furnished herewith.