

Performant Financial Corp
Form 10-Q
May 06, 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 March 31, 2016

or

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

For the transition period from _____ to _____

Commission File Number: 001-35628

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

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

Performant Financial Corporation

333 North Canyons Parkway

Livermore, CA 94551

(925) 960-4800

(Address, including zip code and telephone number, including area code of registrant's principal executive offices)

Indicate by check mark whether the registrant (1) has filed all reports required by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes 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). (Check one):

Large accelerated filer Accelerated filer

Non-accelerated filer 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

The number of shares of Common Stock outstanding as of May 5, 2016 was 49,993,395.

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 FOR THE QUARTER ENDED MARCH 31, 2016
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PERFORMANT FINANCIAL CORPORATION AND SUBSIDIARIES

Consolidated Balance Sheets

(In thousands, except per share amounts)

	March 31, 2016 (Unaudited)	December 31, 2015
Assets		
Current assets:		
Cash and cash equivalents	\$ 48,063	\$ 71,182
Restricted cash	7,516	—
Trade accounts receivable, net of allowance for doubtful accounts of \$386 and \$386, respectively	13,271	17,965
Deferred income taxes	7,137	7,170
Prepaid expenses and other current assets	12,774	12,933
Income tax receivable	315	—
Total current assets	89,076	109,250
Property, equipment, and leasehold improvements, net	24,856	25,515
Identifiable intangible assets, net	24,137	25,074
Goodwill	82,522	82,522
Other assets	169	179
Total assets	\$ 220,760	\$ 242,540
Liabilities and Stockholders' Equity		
Current liabilities:		
Current maturities of notes payable	\$ 16,637	\$ 7,998
Accrued salaries and benefits	6,322	4,761
Accounts payable	527	929
Other current liabilities	5,644	5,615
Income Tax Payable	—	895
Estimated liability for appeals	19,064	19,118
Net payable to client	15,938	14,400
Total current liabilities	64,132	53,716
Notes payable, net of current portion	51,073	84,144
Deferred income taxes	8,564	8,818
Other liabilities	1,965	2,006
Total liabilities	125,734	148,684
Commitments and contingencies		
Stockholders' equity:		
Common stock, \$0.0001 par value. Authorized, 500,000 shares at March 31, 2016 and December 31, 2015; issued and outstanding 49,990 and 49,479 shares at March 31, 2016 and December 31, 2015, respectively	5	5
Additional paid-in capital	62,898	61,808
Retained earnings	32,123	32,043
Total stockholders' equity	95,026	93,856
Total liabilities and stockholders' equity	\$ 220,760	\$ 242,540
See accompanying notes to consolidated financial statements.		

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PERFORMANT FINANCIAL CORPORATION AND SUBSIDIARIES

Consolidated Statements of Operations

(In thousands, except per share amounts)

(Unaudited)

	Three Months Ended March 31,	
	2016	2015
Revenues	\$38,279	\$38,559
Operating expenses:		
Salaries and benefits	21,337	23,724
Other operating expenses	14,357	19,195
Total operating expenses	35,694	42,919
Income (loss) from operations	2,585	(4,360)
Interest expense	(2,432)	(2,385)
Income (loss) before provision for (benefit from) income taxes	153	(6,745)
Provision for (benefit from) income taxes	73	(2,343)
Net income (loss)	\$80	\$(4,402)
Net income (loss) per share		
Basic	\$0.00	\$(0.09)
Diluted	\$0.00	\$(0.09)
Weighted average shares		
Basic	49,643	49,357
Diluted	50,189	49,357

See accompanying notes to consolidated financial statements.

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PERFORMANT FINANCIAL CORPORATION AND SUBSIDIARIES

Consolidated Statements of Comprehensive Income

(In thousands)

(Unaudited)

	For the Three Months Ended March 31, 2016	2015
Net income (loss)	\$80	\$(4,402)
Other comprehensive income:		
Foreign currency translation adjustment	14	—
Comprehensive income (loss)	\$94	\$(4,402)

See accompanying notes to consolidated financial statements.

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PERFORMANT FINANCIAL CORPORATION AND SUBSIDIARIES

Consolidated Statements of Cash Flows

(In thousands)

(Unaudited)

	Three Months Ended March 31,	
	2016	2015
Cash flows from operating activities:		
Net income (loss)	\$80	\$(4,402)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Loss on disposal of asset	9	—
Depreciation and amortization	3,390	3,542
Deferred income taxes	(570)	(70)
Stock-based compensation	1,204	1,003
Interest expense from debt issuance costs and amortization of discount note payable	279	354
Write-off unamortized debt issuance costs	468	—
Changes in operating assets and liabilities:		
Trade accounts receivable	4,694	438
Prepaid expenses and other current assets	159	(80)
Income tax receivable	(315)	(2,331)
Other assets	10	135
Accrued salaries and benefits	1,561	1,073
Accounts payable	(402)	(205)
Other current liabilities	171	(1,444)
Income taxes payable	(895)	—
Estimated liability for appeals	(54)	50
Net payable to client	1,538	2,737
Other liabilities	(41)	723
Net cash provided by operating activities	11,286	1,523
Cash flows from investing activities:		
Purchase of property, equipment, and leasehold improvements	(1,803)	(1,777)
Net cash used in investing activities	(1,803)	(1,777)
Cash flows from financing activities:		
Repayment of notes payable	(24,769)	(2,455)
Restricted cash for repayment of notes payable	(7,516)	—
Debt issuance costs paid	(410)	—
Taxes paid related to net share settlement of stock awards	(169)	—
Proceeds from exercise of stock options	310	22
Income tax benefit (shortfall) from employee stock options	80	(46)
Payment of purchase obligation	(142)	(250)
Net cash used in financing activities	(32,616)	(2,729)
Effect of foreign currency exchange rate changes on cash	14	—
Net decrease in cash and cash equivalents	(23,119)	(2,983)
Cash and cash equivalents at beginning of period	71,182	80,298
Cash and cash equivalents at end of period	\$48,063	\$77,315
Supplemental disclosures of cash flow information:		
Cash paid for income taxes	\$1,760	\$101

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Cash paid for interest	\$1,688	\$2,031
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See accompanying notes to consolidated financial statements.

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PERFORMANT FINANCIAL CORPORATION AND SUBSIDIARIES

Notes To Consolidated Financial Statements

For the Three Months Ended March 31, 2016 and 2015

(Unaudited)

1. Organization and Description of Business

(a) Basis of Presentation and Organization

The accompanying unaudited consolidated financial statements have been prepared in accordance with U.S. Generally Accepted Accounting Principles, or U.S. GAAP, for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and notes required by U.S. GAAP for complete financial statements. In the opinion of management, the unaudited interim financial statements furnished herein include all adjustments necessary (consisting only of normal recurring adjustments) for a fair presentation of our and our subsidiaries' financial position at March 31, 2016, the results of our operations for the three months ended March 31, 2016 and 2015 and cash flows for the three months ended March 31, 2016 and 2015. Interim financial statements are prepared on a basis consistent with our annual consolidated financial statements. The interim financial statements included herein should be read in conjunction with the consolidated financial statements and related notes included in our annual report on Form 10-K for the years ended December 31, 2015, 2014, and 2013.

The Company is a leading provider of technology-enabled recovery and analytics services in the United States. The Company's services help identify, restructure and recover delinquent or defaulted assets and improper payments for both government and private clients in a broad range of markets. Company clients typically operate in complex and regulated environments and outsource their recovery needs in order to reduce losses on billions of dollars of defaulted student loans, improper healthcare payments and delinquent state tax and federal treasury receivables. The Company generally provides services on an outsourced basis, where we handle many or all aspects of the clients' recovery processes.

The Company's consolidated financial statements include the operations of Performant Financial Corporation (PFC), its wholly owned subsidiary Performant Business Services, Inc., and its wholly owned subsidiaries Performant Recovery, Inc. (Recovery) and Performant Technologies, Inc. PFC is a Delaware corporation headquartered in California and was formed in 2003. Performant Business Services, Inc. is a Nevada corporation founded in 1997. Recovery is a California corporation founded in 1976. Performant Technologies, Inc. is a California corporation that was formed in 2004. All significant intercompany balances and transactions have been eliminated in consolidation. The Company is managed and operated as one business, with a single management team that reports to the Chief Executive Officer.

The preparation of the consolidated financial statements in conformity with U.S. GAAP, requires management to make certain estimates and assumptions that affect the reported amounts of assets and liabilities, primarily accounts receivable, intangible assets, goodwill, estimated liability for appeals, accrued expenses, and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting periods. Our actual results could differ from those estimates.

(b) Revenues, Accounts Receivable, and Estimated Liability for Appeals

Revenue is recognized upon the collection of defaulted loan and debt payments. Loan rehabilitation revenue is recognized when the rehabilitated loans are sold (funded) by clients. Incentive revenue is recognized upon receipt of official notification of incentive award from customers. Under the Company's Medicare Recovery Audit Contractor, or RAC, contract with Centers for Medicare and Medicaid Services, or CMS, the Company recognizes revenues when the healthcare provider has paid CMS for a given claim or has agreed to an offset against other claims by the provider. Providers have the right to appeal a claim and may pursue additional appeals if the initial appeal is found in favor of CMS. The Company accrues an estimated liability for appeals at the time revenue is recognized based on the

Company's estimate of the amount of revenue probable of being refunded to CMS following successful appeal. In addition, if the Company's estimate of the liability for appeals with respect to revenues recognized during a prior period changes, the Company increases or decreases current period accruals based on such change in estimated liability. At March 31, 2016 a total of \$18.9 million was presented as an allowance against revenue, representing the Company's estimate of claims that may be overturned. Of this, an immaterial amount was related to accounts receivable and \$18.9 million was related to commissions which had already been received. The zero allowance against accounts receivable at March 31, 2016 is due to the fact that the receivable from CMS is netted against an offsetting payable for overturned audits, and at March 31, 2016, the amount of the payable exceeded the amount of the receivable as discussed in note 1(c). In addition to the \$18.9 million related to the RAC contract with CMS, the Company has accrued \$0.2 million of additional estimated liability for appeals related to other healthcare contracts. The total accrued liability for appeals of \$19.1

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million has been presented in the caption estimated liability for appeals at March 31, 2016. At December 31, 2015, the total appeals-related liability was \$19.1 million. The \$19.1 million balance at March 31, 2016 and December 31, 2015, represent the Company's best estimate of the probable amount of losses related to appeals of claims for which commissions were previously collected. In addition to the \$19.1 million amount accrued at March 31, 2016, the Company estimates that it is reasonably possible that it could be required to pay an additional amount up to approximately \$5.4 million as a result of potentially successful appeals. To the extent that required payments by the Company exceed the amount accrued, revenues in the applicable period would be reduced by the amount of the excess.

(c) Net Payable to Client

The Company nets outstanding accounts receivable invoices from an audit and recovery contract against payables for overturned audits. The overturned audits are netted against current fees due on the invoice to the client when they are processed by the client's system. The "Net payable to client" balance of \$15.9 million represents the excess of payables for overturned audits at March 31, 2016. At December 31, 2015, the net of the "Net payable to client" balance of \$14.4 million was comprised of payables of \$15.4 million for overturned audits offset by outstanding receivables of \$1.0 million. The Company expects that the net payable-to-client balance will be paid to the client within the next twelve months.

(d) Prepaid Expenses and Other Current Assets

At March 31, 2016, prepaid expenses and other current assets includes \$5.7 million of amounts estimated to become due from subcontractors. The Company employs subcontractors to audit claims as part of an audit & recovery contract, and to the extent that audits by these subcontractors are overturned on appeal, the fees associated with such claims are contractually refundable to the Company. At March 31, 2016, the receivable associated with estimated future overturns of subcontractor audits was \$5.7 million. In addition, at March 31, 2016, prepaid expenses and other current assets includes a net receivable of \$3.8 million for subcontractor fees for already overturned audits refundable to the Company once the Company refunds its fees to the client as prime contractor. By comparison, at December 31, 2015, prepaid expenses and other current assets included \$5.7 million of estimated future overturns of subcontractor audits, as well as a net receivable of \$3.8 million for subcontractor fees for already overturned audits refundable to the Company once the Company refunds its fees to the client as prime contractor.

(e) Impairment of Long-Lived Assets

Long-lived assets are evaluated for impairment whenever events or changes in circumstances indicate that the carrying amount of such assets or intangibles may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of the assets to future undiscounted net cash flows expected to be generated by the assets. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds the fair value of the assets. There was no impairment expense for long-lived assets for the three months ended March 31, 2016. For the three months ended March 31, 2015, an impairment expense of \$0.2 million was recognized to account for the loss of a client and it has been included in other operating expenses in the consolidated statements of operations.

(f) Restricted Cash

At March 31, 2016, restricted cash included in current assets on our consolidated balance sheet was \$7.5 million. As discussed in Note 3, in February 2016 the Company deposited \$7.5 million into a segregated deposit account in connection with the Fourth Amendment to our credit agreement. The cash in this segregated deposit account is restricted because it is subject to the exclusive control of the administrative agent as set forth in our credit agreement.

(g) Recent Accounting Pronouncements

Accounting Standards Adopted

Effective in the first quarter of 2016, we adopted FASB's ASU 2015-03, "Simplifying the Presentation of Debt Issuance Costs," in conjunction with their initiative to reduce complexity in accounting standards. This guidance

requires that debt issuance costs related to a recognized debt liability be presented in the balance sheet as a direct deduction from the carrying amount of that debt liability, consistent with presentation of a debt discount. The standard requires retrospective application and represents a change in accounting principle. Although the new guidance had no impact on the Company's results of operations, the debt issuance costs presented as assets within the Company's consolidated balance sheet which amounted to \$1.9 million and \$2.1 million, as of March 31, 2016 and December 31, 2015, respectively, have been reclassified as a reduction of the related debt liability.

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Effective in the first quarter of 2016, the FASB issued ASU 2015-16, “Simplifying the Accounting for Measurement-Period Adjustments,” that eliminates the requirement for an acquirer in a business combination to account for measurement-period adjustments retrospectively. The adoption of ASU 2015-16 did not have a material impact on the Company’s consolidated financial statements.

Recently Issued Accounting Standards

In May 2014, FASB issued an ASU that amends the FASB ASC by creating a new Topic 606, Revenue from Contracts with Customers. The new guidance will supersede the revenue recognition requirements in Topic 605, Revenue Recognition, and most industry-specific guidance on revenue recognition throughout the Industry Topics of the Codification. The core principle of the guidance is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. To achieve that core principle, an entity should apply the following steps:

Step 1: Identify the contract(s) with a customer.

Step 2: Identify the performance obligations in the contract.

Step 3: Determine the transaction price.

Step 4: Allocate the transaction price to the performance obligations in the contract.

Step 5: Recognize revenue when (or as) the entity satisfies a performance obligation.

In addition, an entity should disclose sufficient qualitative and quantitative information to enable users of financial statements to understand the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers. The amendments in this ASU are effective for annual reporting periods beginning after December 15, 2017, including interim periods within that reporting period. Early adoption is not permitted. This amendment is to be either retrospectively adopted to each prior reporting period presented or retrospectively with the cumulative effect of initially applying this ASU recognized at the date of initial application. On July 9, 2015, the FASB decided to defer the effective date by one year, to annual reporting periods beginning on or after December 15, 2017, including interim periods within that reporting period. The FASB also voted to permit early adoption of the guidance but no earlier than the original effective date. The Company is currently evaluating the impact of the adoption of this guidance on its consolidated financial statements.

In August 2014, the FASB issued Accounting Standards Update No. 2014-15, “Presentation of Financial Statements - Going Concern”, which addresses management’s responsibility to evaluate whether there is substantial doubt about an entity’s ability to continue as a going concern and to provide related footnote disclosures. Management’s evaluation should be based on relevant conditions and events that are known, and reasonably knowable, at the date that the financial statements are issued. This new guidance will be effective for the first interim period within annual reporting periods beginning after December 31, 2016 with early adoption permitted. We have not adopted this guidance early and are currently evaluating the effect on our consolidated financial statements.

In November 2015, the FASB issued ASU 2015-17, “Income Taxes: Balance Sheet Classification of Deferred Taxes” which simplifies the current presentation of separately classifying deferred tax assets and deferred tax liabilities as current and noncurrent in a classified balance sheet by requiring companies to present them as noncurrent. This new guidance is effective for annual reporting periods beginning after December 15, 2016, including interim periods within such annual reporting periods with early adoption permitted. We have not adopted this guidance early and are currently evaluating the effect on our consolidated financial statements.

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

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2. Property, Equipment, and Leasehold Improvements

Property, equipment, and leasehold improvements consist of the following at March 31, 2016 and December 31, 2015 (in thousands):

	March 31, December 31,	
	2016	2015
Land	\$ 1,122	\$ 1,122
Building and leasehold improvements	6,093	6,053
Furniture and equipment	5,407	5,390
Computer hardware and software	68,737	67,353
	81,359	79,918
Less accumulated depreciation and amortization	(56,503)	(54,403)
Property, equipment and leasehold improvements, net	\$ 24,856	\$ 25,515

Depreciation expense of property, equipment and leasehold improvements was \$2.5 million and \$2.4 million for the three months ended March 31, 2016 and 2015, respectively.

3. Credit Agreement

On February 19, 2016, the Company entered into Amendment No. 4 to its Credit Agreement (Fourth Amendment) in which certain financial covenants were amended. Under the Fourth Amendment, the Company's financial covenants were modified as follows:

The annual capital expenditure limitation of \$12.5 million, which was in effect for the year ending December 31, 2016, has been revised under the Fourth Amendment to be \$8 million for the years ending December 31, 2016 and December 31, 2017.

The total debt to EBITDA ratio of 3.25 to 1.0, which was in effect for the computation periods ending as of March 31, 2017 and June 30, 2017, has been revised under the Fourth Amendment to be 4.75 to 1.0 for those periods.

The interest coverage ratio of 2.50 to 1.0, which was in effect for the computation period ending as of December 31, 2016, has been revised under the Fourth Amendment to be 2.0 to 1.0 for the computation period ending as of December 31, 2016 and 1.75 to 1.0 for the computation periods ending as March 31, 2017 and June 30, 2017.

The fixed charge coverage ratio of 1.20 to 1.0, which was in effect for the quarterly computation periods under the Credit Agreement ending as of March 31, 2017 through December 31, 2017, has been revised under the Fourth Amendment to apply only to the computation periods ending as September 30, 2017 and December 31, 2017.

The required minimum adjusted cash balance of \$30.0 million, which was in effect from March 31, 2016 through December 31, 2016, has been revised under the Fourth Amendment to be \$10.0 million from March 31, 2016 through September 30, 2016.

The minimum trailing twelve month EBITDA of \$20.0 million, which was in effect from March 31, 2016 through December 31, 2016, has been revised under the Fourth Amendment by shortening such period to extend until June 30, 2016.

Interest charged under the Credit Agreement as revised by the Fourth Amendment with respect to the Term A loan revolving loan advances is now charged either at Prime +5.75% or LIBOR + 6.75%, and interest with respect to the Term B loan is now charged either at Prime + 6.25% or LIBOR + 7.25%. In connection with the Fourth Amendment, the Company voluntarily prepaid \$22.5 million under the Credit Agreement, which was applied ratably to the Term A loan and the Term B loan.

In addition, the Company deposited \$7.5 million into a deposit account which is subject to the exclusive control of the Agent. Pursuant to the Fourth Amendment, these funds will be remitted to the Agent for application to the term loans or other obligations, as applicable, under the Credit Agreement on the earlier to occur of (i) September 30, 2016 (or

such later date not more than thirty (30) days thereafter as may be agreed by Agent in its sole discretion) and (ii) the occurrence and continuation of an event of default; however, all or a portion of these funds may also be returned the Company if the Agent and the requisite lenders under the Credit Agreement elect otherwise in their sole discretion.

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

Year Ending December 31, Amount	
Remainder of 2016	\$ 14,307
2017	3,959
2018	51,223
2019	—
2020	—
Thereafter	—
Total	\$ 69,489

Due to delays in the award of the new contracts by CMS and the Department of Education, significant limitations on our audit and recovery activity during the CMS contract transition period, suspension of student loan placements to us from the Department of Education during the contract transition period and recovery fee reductions in the student lending market, we have been actively restructuring both our variable and fixed expenses consistent with our reduced operations and in order to maintain compliance with our debt covenants under our credit agreement. Our current financial projections show that we expect to be able to maintain compliance with these covenants through the second quarter of 2017. However, the factors noted above have had and, until resolved, will continue to have a significant negative effect on our revenues and earnings and our ability to continue to comply with these covenants. Accordingly, we expect to seek further modifications to the covenants from our lenders or refinance our indebtedness. Our inability to maintain long-term compliance with our debt covenants, or to refinance or restructure the terms of our indebtedness on commercially reasonable terms or at all, would have an adverse effect, which could be material on our business, financial condition and results of operations, as well as our ability to satisfy our debt obligations.

In addition, due to the delays in the award of the new contracts from the Department of Education and CMS, we implemented cost and expense reductions during 2015 and the first quarter of 2016 that included a significant reduction in personnel. To the extent we are able to secure new contracts with the Department of Education or CMS, we will incur significant expenses to hire additional personnel that will be required to provide services under any such new contract that may require us to obtain additional financing. There can be no assurance that we will be able to obtain such financing on favorable terms, or at all.

4. Commitments and Contingencies

We have entered into various non-cancelable operating lease agreements for certain of our office facilities and equipment with original lease periods expiring between 2016 and 2021. Certain of these arrangements have free rent periods and /or escalating rent payment provisions, and we recognize rent expense under such arrangements on a straight-line basis.

Future minimum rental commitments under non-cancelable leases as of March 31, 2016 are as follows (in thousands):

Year Ending December 31, Amount	
Remainder of 2016	\$ 1,650
2017	1,764
2018	942
2019	872
2020	842
Thereafter	310
Total	\$ 6,380

Operating lease expense was \$0.7 million and \$0.8 million for the three months ended March 31, 2016 and 2015, respectively.

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5. Stock-based Compensation

(a) Stock Options

Total stock-based compensation expense charged as salaries and benefits expense in the consolidated statements of operations was \$1.2 million and \$1.0 million for the three months ended March 31, 2016 and 2015, respectively.

The following table shows stock option activity for the three months ended March 31, 2016:

	Outstanding Options	Weighted average exercise price per share	Weighted average remaining contractual life (Years)	Aggregate Intrinsic Value (in thousands)
Outstanding at December 31, 2015	4,117,123	\$ 6.92	5.64	\$ 1,211
Granted	115,000	1.74		
Forfeited	(110,371)	7.36		
Exercised	(350,767)	0.88		
Outstanding at March 31, 2016	3,770,985	\$ 7.31	5.49	\$ 814
Vested, exercisable, expected to vest ⁽¹⁾ at March 31, 2016	3,720,473	\$ 7.31	5.46	\$ 814
Exercisable at March 31, 2016	2,724,781	\$ 6.97	4.68	\$ 814

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

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

(b) Restricted Stock Units and Performance Stock Units

The following table summarizes restricted stock unit and performance stock unit activity for the three months ended March 31, 2016:

	Number of Awards	Weighted average grant date fair value per share
Outstanding at December 31, 2015	1,229,274	\$ 4.67
Granted	1,103,500	1.74
Forfeited	(55,050)	5.64
Vested and converted to shares	(261,374)	3.47
Outstanding at March 31, 2016	2,016,350	\$ 3.20
Expected to vest at March 31, 2016	1,915,581	\$ 3.20

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

6. Income Taxes

Our effective income tax rate changed to 47.7% for the three months ended March 31, 2016 from 34.7% for the three months ended March 31, 2015. The increase in the effective tax rate is primarily due to income from operations generated in the three months ended March 31, 2016 compared to the loss from operations incurred for the three months ended March 31, 2015 and the resulting impact of the discrete items on the effective tax rate.

We file income tax returns with the U.S. federal government and various state jurisdictions. We operate in a number of state and local jurisdictions, most of which have never audited our records. Accordingly, we are subject to state and local income tax examinations based upon the various statutes of limitations in each jurisdiction. For tax years before 2011, the Company is no longer subject to California, Texas and certain state tax examinations. For tax years before 2012, the Company is no longer

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subject to Federal and certain other state tax examinations. We are currently being examined by the Franchise Tax Board of California for tax years 2011 and 2012, and the State of New York for tax years 2011, 2012, and 2013.

7. Earnings per Share

For the three months ended March 31, 2016 and 2015, basic income per share is calculated by dividing net income by the sum of the weighted average number of shares of Common Stock outstanding during the period. Diluted income per share is calculated by dividing net income by the weighted average number of shares of Common Stock and dilutive common share equivalents outstanding during the period. Common share equivalents consist of stock options, restricted stock units, and performance stock units. When there is a loss in the period, dilutive common share equivalents are excluded from the calculation of diluted earnings per share, as their effect would be anti-dilutive. For example, for the three months ended March 31, 2015, dilutive common share equivalents have been excluded, and diluted weighted average shares outstanding are the same as basic average shares outstanding. When there is net income in the period, the Company excludes stock options, restricted stock units, and performance stock units from the calculation of diluted earnings per share when the combined exercise price, unamortized fair value and excess tax benefits of the options exceed the average market price of the Company's common stock because their effect would be anti-dilutive. For the three months ended March 31, 2016, the Company excluded 4,438,043 options from the calculation of diluted earnings per share because their effect would be anti-dilutive.

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

	Three Months Ended March 31, 2016 2015	
Weighted average shares outstanding – basic	49,643	49,357
Dilutive effect of stock options	546	—
Weighted average shares outstanding – diluted	50,189	49,357

8. Subsequent Events

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

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

You should read the following discussion in conjunction with our condensed consolidated financial statements (unaudited) and related notes included elsewhere in this report. This report on Form 10-Q contains forward-looking statements that involve risks and uncertainties. The words "believe," "may," "will," "estimate," "continue," "anticipate," "design," "intend," "expect" and similar expressions are intended to identify forward-looking statements. We have based these forward-looking statements largely on our current expectations and projections about future events and trends that we believe may affect our financial condition, results of operations, strategy, short-term and long-term business operations and objectives, and financial needs. These forward-looking statements are subject to a number of risks, uncertainties and assumptions, including those described in "Risk Factors" under Item 1A of Part II of this report. In light of these risks, uncertainties and assumptions, the forward-looking events and trends discussed in this report may not occur, and actual results could differ materially and adversely from those anticipated or implied in the forward-looking statements. Forward-looking statements include, but are not limited to, statements about our: opportunities and expectations for growth in the student lending, healthcare and other markets; anticipated trends and challenges in our business and competition in the markets in which we operate; our client relationships and our ability to maintain such client relationships; the adaptability of our technology platform to new markets and processes; our ability to invest in and utilize our data and analytics capabilities to expand our capabilities; the sufficiency of our appeals reserve; our growth strategy of expanding in our existing markets and considering strategic alliances or acquisitions; our ability to meet our liquidity and working capital needs; maintaining, protecting and enhancing our intellectual property; our expectations regarding future expenses; expected future financial performance; and our ability to comply with and adapt to industry regulations and compliance demands. The forward-looking statements in this report speak only as of the date hereof. We expressly disclaim any obligation or undertaking to release publicly any updates or revisions to any forward-looking statements contained herein to reflect any change in our expectations with regard thereto or any change in events, conditions or circumstances on which any such statement is based.

Overview

We provide technology-enabled recovery and related analytics services in the United States. Our services help identify and recover delinquent or defaulted assets and improper payments for both government and private clients in a broad range of markets. Our clients typically operate in complex and regulated environments and outsource their recovery needs in order to reduce losses on billions of dollars of defaulted student loans, improper healthcare payments and delinquent state tax and federal treasury and other receivables. We generally provide our services on an outsourced basis, where we handle many or all aspects of our clients' recovery processes.

Our revenue model is generally success-based as we earn fees on the aggregate amount of funds that we enable our clients to recover. Our services do not require any significant upfront investments by our clients and offer our clients the opportunity to recover significant funds otherwise lost. Because our model is based upon the success of our efforts and the dollars we enable our clients to recover, our business objectives are aligned with those of our clients and we are generally not reliant on their spending budgets. Furthermore, our business model does not require significant capital expenditures and we do not purchase loans or obligations.

Sources of Revenues

We derive our revenues from services for clients in a variety of different markets. These markets include our two largest markets, student lending and healthcare, as well as our other markets which include, but are not limited to, delinquent state taxes and federal Treasury and other receivables.

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	Three Months Ended March 31, 2016 2015 (in thousands)	
Student Lending:		
Department of Education	\$7,355	\$11,725
Guaranty Agencies & Other	22,269	15,327
Total of Student Lending	29,624	27,052
Healthcare:		
CMS RAC	1,196	3,210
Commercial	1,533	2,070
Total of Healthcare	2,729	5,280
Other:	5,926	6,227
Total Revenues	\$38,279	\$38,559

Student Lending

We derive the majority of our revenues from the recovery of student loans. These revenues are contract-based and consist primarily of contingency fees based on a specified percentage of the amount we enable our clients to recover. Our contingency fee percentage for a particular recovery depends on the type of recovery facilitated. We also receive incremental performance incentives based upon our performance as compared to other contractors with the Department of Education, which are comprised of additional inventory allocation volumes and incentive fees. We are currently subject to a competitive rebidding process for the next contract with the Department of Education. While five other recovery service providers have had their contracts extended by the Department of Education past the original April 2015 expiration date, we did not receive such an extension from the Department of Education. We submitted our proposal for a new contract to the Department of Education in February 2016, but it is uncertain as to when any new contracts will be awarded. We do not anticipate receiving any new loan placements from the Department of Education until the new contracts are awarded. Due to the nine month rehabilitation process for loans placed with us by the Department of Education, there was minimal impact on our revenues in 2015 as a result of not receiving an extension of our current contract. However, the absence of placements of new student loans from the Department of Education since the expiration of our prior contract in April 2015 will have a negative impact on our revenues in 2016.

We believe the size and the composition of our student loan inventory at any point provides us with a significant degree of revenue visibility for our student loan revenues. Based on data compiled from over two decades of experience with the recovery of defaulted student loans, at the time we receive a placement of student loans, we are able to make a reasonably accurate estimate of the recovery outcomes likely to be derived from such placement and the revenues we are likely able to generate based on the anticipated recovery outcomes.

Our key metric in evaluating our student lending business is Placement Volume. Our Placement Volume represents the dollar volume of defaulted student loans first placed with us during the specified period by public and private clients for recovery. Placement Volume allows us to measure and track trends in the amount of inventory our clients in the student lending market are placing with us during any period. The revenues associated with the recovery of a portion of these loans may be recognized in subsequent accounting periods, which assists management in estimating future revenues and in allocating resources necessary to address current Placement Volumes.

Three Months Ended
March 31,
2016 2015
(in thousands)

Student Lending Placement Volume:

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Department of Education	\$5,082	\$914,546
Guaranty Agencies and Other	580,099	1,261,272
Total Student Lending Placement Volume	\$585,181	\$2,175,818

There are five potential outcomes to the student loan recovery process from which we generate revenues. These outcomes include: full repayment, recurring payments, rehabilitation, loan restructuring and wage garnishment. Of these five

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potential outcomes, our ability to rehabilitate defaulted student loans is the most significant component of our revenues in this market. Generally, a loan is considered successfully rehabilitated after the student loan borrower has made nine consecutive qualifying monthly payments and our client has notified us that it is recalling the loan. Once we have structured and implemented a repayment program for a defaulted borrower, we (i) earn a percentage of each periodic payment collected up to and including the final periodic payment prior to the loan being considered “rehabilitated” by our clients, and (ii) if the loan is “rehabilitated,” then we are paid a one-time percentage of the total amount of the remaining unpaid balance. As stated above, since July 2015, our contract with the Department of Education has provided for a fixed fee of \$1,710 for each rehabilitated loan. The fees we are paid vary by recovery outcome as well as by contract. For non-government-supported student loans we are generally only paid contingency fees on two outcomes: full repayment or recurring repayments. The table below describes our typical fee structure for each of these five outcomes.

Student Loan Recovery Outcomes

Full Repayment	Recurring Payments	Rehabilitation	Loan Restructuring	Wage Garnishment
<ul style="list-style-type: none"> • Repayment in full of the loan 	<ul style="list-style-type: none"> • Regular structured payments, typically according to a renegotiated payment plan 	<ul style="list-style-type: none"> • After a defaulted borrower has made nine consecutive recurring payments, the loan is eligible for rehabilitation 	<ul style="list-style-type: none"> • Restructure and consolidate a number of outstanding loans into a single loan, typically with one monthly payment and an extended maturity 	<ul style="list-style-type: none"> • If we are unable to obtain voluntary repayment, payments may be obtained through wage garnishment after certain administrative requirements are met
<ul style="list-style-type: none"> • We are paid a percentage of the full payment that is made 	<ul style="list-style-type: none"> • We are paid a percentage of each payment 	<ul style="list-style-type: none"> • We are paid based on a percentage of the overall value of the rehabilitated loan or for the Department of Education, a fixed fee 	<ul style="list-style-type: none"> • We are paid based on a percentage of overall value of the restructured loan 	<ul style="list-style-type: none"> • We are paid a percentage of each payment

For certain guaranty agency, or GA, clients, we have entered into Master Service Agreements, or MSAs. Under these agreements, clients provide their entire inventory of outsourced loans or receivables to us for recovery on an exclusive basis, rather than just a portion, as with traditional contracts that are split among various service providers. In certain circumstances, we engage subcontractors to assist in the recovery of a portion of the client’s portfolio. We also receive success fees for the recovery of loans under MSAs and our revenues under MSA arrangements include fees earned by the activities of our subcontractors. As of March 31, 2016, we had three MSA clients in the student loan market. In October 2014, the Department of Education announced a change in the structure for the payment of fees to recovery contractors upon rehabilitation of student loans under the existing recovery contract. The new fee structure provides for a fixed fee of \$1,710 for each loan that is rehabilitated. Previously, the fee had been based on a percentage of the principal amount of the rehabilitated loan. The change to the fee structure became effective for student loans rehabilitated on or following July 1, 2015.

Further, the Bipartisan Budget Act of 2013, which was signed into law by President Obama on December 26, 2013, reduced the compensation paid to GAs for the rehabilitation of student loans, effective July 1, 2014. This “revenue enhancement” measure reduced the amount that GAs can charge borrowers from 18.5% to 16.0% of the outstanding loan balance, when a rehabilitated loan is sold by the GA and eliminated entirely the GAs retention of 18.5% of the outstanding loan balance as a fee for rehabilitation services. The reduction in compensation the GAs receive resulted in a decrease in the contingency fee percentage that we receive from the GAs for assisting in the rehabilitation of defaulted student loans.

As a result of the fee reductions from the Department of Education and the GAs discussed above, our revenues from student lending in the first quarter of 2016 were approximately 10% lower than in the comparable period in 2015. Other factors contributing to the reduction in student lending revenues include an increase in the number of student

loans eligible for rehabilitation due to income based repayment, which has the effect of reducing the number of loan consolidations which have a shorter payment cycle, and continuing delays in the recognition of some revenues due to additional documentation requirements for income based repayment first imposed during the third quarter of 2014.

Healthcare

We derive revenues from the healthcare market from our RAC contract, under which we are the prime contractor responsible for detecting improperly paid Part A and Part B Medicare claims in 12 states in the Northeastern United States. Revenues earned under the RAC contract are driven by the identification of improperly paid Medicare claims through both automated and manual review of such claims. We are paid contingency fees by CMS based on a percentage of the dollar amount of claims recovered by CMS as a result of our efforts. We recognize revenue when the provider pays CMS or incurs an

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offset against future Medicare claims. The revenues we recognize are net of our estimate of claims that will be overturned by appeal following payment by the provider.

We are currently involved in a competitive rebidding process for four new RAC contracts with CMS. The timing of new RAC contract awards remains uncertain. The bidding process has been delayed by pre-award protests and litigation regarding certain payment terms that were proposed by CMS in the new RAC contract proposals. In anticipation of the award of new RAC contracts, beginning in 2013 CMS has adopted a series of contract transition procedures that have restricted our ability to request medical records for audit and has otherwise suspended our ability to perform any audit services for certain periods of time, thus adversely affected our revenues under this contract. In addition to periods of suspended activity, the contract transition rules have limited scope of our permitted audit activities as CMS has generally not permitted audits of periodic interim payment, or PIP providers and has also placed additional restrictions on the types of claims we are permitted to audit and number of medical records we are permitted to request. Although we entered into a contract modification with CMS to extend our auditing services under our existing RAC contract through July 31, 2016, CMS has further restricted the types of reviews and the types of claims subject to audit, which has resulted in a significant reduction in claim recovery volume and revenues from the healthcare market. Revenues for the quarter ending March 31, 2016 were lower than for the same period last year; and absent a significant change in the scope of the permitted audit activities, we expect that our revenues from the RAC contract will continue to be significantly lower in 2016.

In connection with our RAC contract, CMS has announced a settlement offer to pay hospitals 68% of what they have billed Medicare to settle a backlog of pending appeals challenging Medicare's denials of reimbursement for certain types of short-term care. The implication of this settlement offer related to claims for which fees have already been paid to recovery auditors under existing RAC contracts is unclear at this time, but we may be obligated to repay certain amounts that we previously received from CMS depending on the final terms of any such settlement. We accrue an estimated liability for appeals based on the amount of commissions received which are subject to appeal and which we estimate are probable of being returned to providers following successful appeal. The \$18.9 million balance as of March 31, 2016, represents our best estimate of the probable amount we may be required to refund related to appeals of claims for which commissions were previously collected. We estimate that it is reasonably possible that we could be required to pay an additional amount up to approximately \$5.4 million as a result of potentially successful appeals in excess of the amount we accrued as of March 31, 2016.

In connection with the award of our initial RAC contract, we outsourced certain aspects of our healthcare recovery process to three different subcontractors. Two of these subcontractors provided a specific service to us in connection with our claims recovery process, with the third subcontractor, whose services were terminated in December 2015, formerly providing all of the audit and recovery services for claims within a portion of our region. We recognize all of the revenues generated by the claims recovered through our subcontractor relationships, and we recognize the fees that we pay to these subcontractors in our expenses.

For our commercial healthcare business, our business strategy is focused on utilizing our technology-enabled services platform to provide audit, recovery and analytical services for private healthcare payors. We have entered into contracts with several private payors, although these contracts are in the early stage of implementation. Revenues from our commercial healthcare clients were \$1.5 million for the quarter ended March 31, 2016, compared to revenues of \$2.1 million that we earned from our commercial healthcare clients for the same period last year.

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Other

We also derive revenues from the recovery of delinquent state taxes, as well as federal Treasury and other receivables, default aversion services for certain clients including financial institutions and the licensing of hosted technology solutions to certain clients. For our hosted technology services, we license our system and integrate our technology into our clients' operations, for which we are paid a licensing fee. Our revenues for these services include contingency fees, fees based on dedicated headcount to our clients and hosted technology licensing fees.

Costs and Expenses

We generally report two categories of operating expenses: salaries and benefits and other operating expense. Salaries and benefits expenses consist primarily of salaries and performance incentives paid and benefits provided to our employees. Other operating expense includes expenses related to our use of subcontractors, other production related expenses, including costs associated with data processing, retrieval of medical records, printing and mailing services, amortization and other outside services, as well as general corporate and administrative expenses. We expect a significant portion of our expenses to increase as we grow our business. However, we expect certain expenses, including our corporate and general administrative expenses, to grow at a slower rate than our revenues. As a result, and over the long term, we expect our overall expenses to modestly decline as a percentage of revenues.

Factors Affecting Our Operating Results

Our results of operations are influenced by a number of factors, including allocation of placement volume, claim recovery volume, contingency fees, regulatory matters, client retention and macroeconomic factors.

Allocation of Placement Volume

Our clients have the right to unilaterally set and increase or reduce the volume of defaulted student loans or other receivables that we service at any given time. In addition, many of our recovery contracts for student loans and other receivables are not exclusive, with our clients retaining multiple service providers to service portions of their portfolios. Accordingly, the number of delinquent student loans or other receivables that are placed with us may vary from time to time, which may have a significant effect on the amount and timing of our revenues. We believe the major factors that influence the number of placements we receive from our clients in the student loan market include our performance under our existing contracts and our ability to perform well against competitors for a particular client. To the extent that we perform well under our existing contracts and differentiate our services from those of our competitors, we may receive a relatively greater number of placements under these existing contracts and may improve our ability to obtain future contracts from these clients and other potential clients. Further, delays in placement volume, as well as acceleration of placement volume, from any of our large clients may cause our revenues and operating results to vary from quarter to quarter.

Typically we are able to anticipate with reasonable accuracy the timing and volume of placements of defaulted student loans and other receivables based on historical patterns and regular communication with our clients. Occasionally, however, placements are delayed due to factors outside of our control.

Contingency Fees

Our revenues consist primarily of contract-based contingency fees. The contingency fee percentages that we earn are set by our clients or agreed upon during the bid process, and may change from time to time either under the terms of existing contracts or pursuant to the terms of contract renewals. For example, the fees that we earn under our contractual arrangement with the Department of Education have been subject to unilateral change by the Department of Education as a result of the Department of Education's decision to have its recovery vendors promote IBR to defaulted student loans. The IBR program provides flexibility on the required monthly payment for student loan borrowers at an amount intended to be affordable based on a borrower's income and family size. As a result of the increased application of the IBR program to defaulted student loans, we expect that there will be an increase in the number of loans that become eligible for rehabilitation because more defaulted student loan borrowers will be able to make qualifying payments. In connection with the implementation of the IBR program, the Department of Education initially reduced the contingency fee rate that we receive for rehabilitating student loans by approximately 13% effective March 1, 2013.

Further, the Department of Education changed its fee structure to a fixed recovery fee of \$1,710 for each rehabilitated loan, effective as of July 1, 2015. The fixed recovery fee is payable for each loan that is rehabilitated and replaces a recovery fee structure that historically had been based on a percentage of the balance of the rehabilitated loan.

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Regulatory Matters

Each of the markets which we serve is highly regulated. Accordingly, changes in regulations that affect the types of loans, receivables and claims that we are able to service or the manner in which any such delinquent loans, receivables and claims can be recovered will affect our revenues and results of operations. For example, the passage of the Student Aid and Fiscal Responsibility Act, or SAFRA, in 2010 had the effect of transferring the origination of all government-supported student loans to the Department of Education, thereby ending all student loan originations guaranteed by the GAs. Loans guaranteed by the GAs represented approximately 70% of government-supported student loans originated in 2009. While the GAs will continue to service existing outstanding student loans for years to come, this legislation will over time shift the portfolio of student loans that we manage toward the Department of Education, and further concentrate our sources of revenues and increase our reliance on our relationship with the Department of Education. In addition, our entry into the healthcare market was facilitated by passage of the Tax Relief and Health Care Act of 2006, which mandated CMS to contract with private firms to audit Medicare claims in an effort to increase the recovery of improper Medicare payments. Any changes to the regulations that affect the student loan industry or the recovery of defaulted student loans or the Medicare program generally or the audit and recovery of Medicare claims could have a significant impact on our revenues and results of operations.

Client Retention

Our revenues from the student loan market depend on our ability to maintain our contracts with some of the largest providers of student loans. For the three months ended March 31, 2016, three providers of student loans each accounted for more than 10% of our revenues and they collectively accounted for approximately 57% of our total revenues during this period. Our contract with the Department of Education, which generated approximately 19% of our revenues in the first quarter of 2016, is currently the subject to a competitive bidding process. Our contracts with these clients entitle them to unilaterally terminate their contractual relationship with us at any time without penalty. If we lose one of our significant clients, including if one of our significant clients is consolidated by an entity that does not use our services, if the terms of compensation for our services change or if there is a reduction in the level of placements provided by any of these clients, our revenues could decline.

Our contract with CMS for the recovery of improper Medicare payments represented approximately 3% of our total revenues for the three months ended March 31, 2016, compared to approximately 8% for the same period last year. Our audit work under our existing RAC contract expired in June 2014, but we have been permitted to resume certain audit work with respect to a limited number of claims pursuant to a contract extension that runs through July 31, 2016. We are currently participating in a competitive bidding process for the next RAC contract. The award of the new RAC contracts has been delayed due in part to a bid protests and related litigation regarding certain payment terms that were proposed by CMS in the new RAC contract proposals. While we believe our performance under the existing agreement and the experience we have gained in performing this contract position us well to renew the agreement, failure to renew the agreement or renewal on substantially less favorable terms could significantly harm our revenues and results of operations.

Macroeconomic Factors

Certain macroeconomic factors influence our business and results of operations. These include the increasing volume of student loan originations in the U.S. as a result of increased tuition costs and student enrollment, the default rate of student loan borrowers, the growth in Medicare expenditures resulting from increasing healthcare costs, as well as the fiscal budget tightening of federal, state and local governments as a result of general economic weakness and lower tax revenues.

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Critical Accounting Policies

Our consolidated financial statements are prepared in accordance with generally accepted accounting principles in the United States, or GAAP. The preparation of these consolidated financial statements requires us to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues, costs and expenses and related disclosures. We base our estimates on historical experience and on various other assumptions that we believe to be reasonable under the circumstances. In many instances, we could have reasonably used different accounting estimates, and in other instances changes in the accounting estimates are reasonably likely to occur from period-to-period. Accordingly, actual results could differ significantly from the estimates made by our management. To the extent that there are material differences between these estimates and actual results, our future financial statement presentation, financial condition, results of operations and cash flows will be affected. We believe that the accounting policies discussed below are critical to understanding our historical and future performance, as these policies relate to the more significant areas involving management's judgments and estimates.

Revenue Recognition

The majority of our contracts are contingency fee based. We recognize revenues on these contingency fee based contracts when third-party payors remit payments to our clients or remit payments to us on behalf of our clients, and, consequently, the contingency is deemed to have been satisfied. Under our RAC contract with CMS, we recognize revenues when the healthcare provider has paid CMS for a claim or has agreed to an offset against other claims by the provider. Healthcare providers have the right to appeal a claim and may pursue additional level of appeals if the initial appeal is found in favor of CMS. We accrue an estimated liability for appeals at the time revenue is recognized based on our estimate of the amount of revenue probable of being returned to CMS following successful appeal based on historical data and other trends relating to such appeals. In addition, if our estimate of liability for appeals with respect to revenues recognized during a prior period changes, we increase or decrease the estimated liability for appeals in the current period.

This estimated liability for appeals is an offset to revenues on our income statement. Resolution of appeals can take a very long time to resolve and there is a significant backlog in the system for resolving appeals, as over the course of our existing RAC contract, healthcare providers have increased their pursuit of appeals beyond the first and second levels of appeals to the third level of appeal, where cases are heard by administrative law judges, or ALJs. In our experience, decisions at the third level of appeal are the least favorable as ALJs exercise greater discretion and there is less predictability in the ALJ decisions as compared to appeals at the first or second levels. This increase of ALJ appeals and backlog of claims at the third level of appeal is the primary reason our total estimated liability for appeals (consisting of the estimated liability for appeals plus the contra-accounts-receivable estimated allowance for appeals) has grown from a balance of \$16.4 million at December 31, 2013, to \$18.6 million as of December 31, 2014, to 19.0 million at December 31, 2015, and decreased to \$18.9 million as of March 31, 2016. In addition to the \$18.9 million related to the RAC contract with CMS, the Company has accrued \$0.2 million of additional estimated liability for appeals related to other healthcare contracts. The total accrued liability for appeals is therefore \$19.1 million at March 31, 2016.

The \$19.1 million balance as of March 31, 2016, represents our best estimate of the probable amount of losses related to appeals of claims for which commissions were previously collected. We estimate that it is reasonably possible that we could be required to pay up to an additional approximately \$5.4 million as a result of potentially successful appeals. To the extent that required payments by us related to successful appeals exceed the amount accrued, revenues in the applicable period would be reduced by the amount of the excess.

Goodwill

We periodically review the carrying value of intangible assets not subject to amortization, including goodwill, to determine whether an impairment may exist. GAAP requires that goodwill and certain intangible assets not subject to amortization be assessed annually for impairment using fair value measurement techniques.

We assess goodwill for impairment on an annual basis as of November 30 of each year or more frequently if an event occurs or changes in circumstances would more likely than not reduce the fair value of a reporting unit below its

carrying amount. We have the option to perform a qualitative assessment to determine if an impairment is more likely than not to have occurred. If we can support the conclusion that it is more likely than not that the fair value of a reporting unit is greater than its carrying amount, then we would not need to perform the two-step impairment test. If we cannot support such a conclusion, or we do not elect to perform the qualitative assessment, then the first step of the goodwill impairment test is used to identify potential impairment by comparing the fair value of a reporting unit with its carrying amount, including goodwill. The Company performed a Step 1 impairment assessment as of November 30, 2015 and concluded that it was not necessary to perform a Step 2 impairment assessment. The Company performed a qualitative assessment of whether it is more likely than

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not that goodwill value is less than its carrying amount as of March 31, 2016 and concluded that there was no need to perform an impairment test. There was no impairment expense for goodwill for the three months ended March 31, 2016 and 2015.

Impairments of Depreciable Intangible Assets

The balance of depreciable intangible assets was \$24.1 million as of March 31, 2016. We evaluate depreciable intangible assets for impairment whenever events or changes in circumstances indicate that the carrying amount of such assets may not be recoverable. Depreciable intangible assets consist of client contracts and related relationships, and are being amortized over their estimated useful life, which is generally 20 years. We evaluate the client contracts intangible at the individual contract level. The recoverability of such assets is measured by a comparison of the carrying amount of the assets to future undiscounted net cash flows expected to be generated by the assets. If the assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds the fair value of the assets. There was no impairment expense for depreciable intangible assets for the three months ended March 31, 2016. For the year ended December 31, 2015, an impairment expense of \$0.2 million was recognized to account for the loss of a client and it has been included in other operating expenses in the consolidated statements of operations.

Recent Accounting Pronouncements

Accounting Standards Adopted

Effective in the first quarter of 2016, we adopted FASB's ASU 2015-03, "Simplifying the Presentation of Debt Issuance Costs," in conjunction with their initiative to reduce complexity in accounting standards. This guidance requires that debt issuance costs related to a recognized debt liability be presented in the balance sheet as a direct deduction from the carrying amount of that debt liability, consistent with presentation of a debt discount. The standard requires retrospective application and represents a change in accounting principle. Although the new guidance had no impact on the Company's results of operations, the debt issuance costs presented as assets within the Company's consolidated balance sheet which amounted to \$1.9 million and \$2.1 million, as of March 31, 2016 and December 31, 2015, respectively, have been reclassified as a reduction of the related debt liability.

Effective in the first quarter of 2016, the FASB issued ASU 2015-16, "Simplifying the Accounting for Measurement-Period Adjustments," that eliminates the requirement for an acquirer in a business combination to account for measurement-period adjustments retrospectively. The adoption of ASU 2015-16 did not have a material impact on the Company's consolidated financial statements.

Recently Issued Accounting Standards

In May 2014, FASB issued an ASU that amends the FASB ASC by creating a new Topic 606, Revenue from Contracts with Customers. The new guidance will supersede the revenue recognition requirements in Topic 605, Revenue Recognition, and most industry-specific guidance on revenue recognition throughout the Industry Topics of the Codification. The core principle of the guidance is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. To achieve that core principle, an entity should apply the following steps:

Step 1: Identify the contract(s) with a customer.

Step 2: Identify the performance obligations in the contract.

Step 3: Determine the transaction price.

Step 4: Allocate the transaction price to the performance obligations in the contract.

Step 5: Recognize revenue when (or as) the entity satisfies a performance obligation.

In addition, an entity should disclose sufficient qualitative and quantitative information to enable users of financial statements to understand the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers. The amendments in this ASU are effective for annual reporting periods beginning after December 15, 2017, including interim periods within that reporting period. Early adoption is not permitted. This amendment is to be either retrospectively adopted to each prior reporting period presented or retrospectively with the cumulative effect of

initially applying this ASU recognized at the date of initial application. On July 9, 2015, the FASB decided to defer the effective date by one year, to annual reporting periods beginning on or after December 15, 2017, including interim periods within that reporting period. The FASB also voted to permit early adoption of the guidance but no earlier than the original effective date. The Company is currently evaluating the impact of the adoption of this guidance on its consolidated financial statements.

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In August 2014, the FASB issued Accounting Standards Update No. 2014-15, “Presentation of Financial Statements - Going Concern”, which addresses management’s responsibility to evaluate whether there is substantial doubt about an entity’s ability to continue as a going concern and to provide related footnote disclosures. Management’s evaluation should be based on relevant conditions and events that are known, and reasonably knowable, at the date that the financial statements are issued. This new guidance will be effective for the first interim period within annual reporting periods beginning after December 31, 2016 with early adoption permitted. We have not adopted this guidance early and are currently evaluating the effect on our consolidated financial statements.

In November 2015, the FASB issued ASU 2015-17, “Income Taxes: Balance Sheet Classification of Deferred Taxes” which simplifies the current presentation of separately classifying deferred tax assets and deferred tax liabilities as current and noncurrent in a classified balance sheet by requiring companies to present them as noncurrent. This new guidance is effective for annual reporting periods beginning after December 15, 2016, including interim periods within such annual reporting periods with early adoption permitted. We have not adopted this guidance early and are currently evaluating the effect on our consolidated financial statements.

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

Results of Operations

Three Months Ended March 31, 2016 compared to the Three Months Ended March 31, 2015

The following table represents our historical operating results for the periods presented:

	Three Months Ended March 31,			
	2016	2015	\$ Change	% Change
	(in thousands)			
Consolidated Statement of Operations Data:				
Revenues	\$38,279	\$38,559	\$(280)	(1)%
Operating expenses:				
Salaries and benefits	21,337	23,724	(2,387)	(10)%
Other operating expenses	14,357	19,195	(4,838)	(25)%
Total operating expenses	35,694	42,919	(7,225)	(17)%
Income from operations	2,585	(4,360)	6,945	159 %
Interest expense	(2,432)	(2,385)	(47)	2 %
Income before provision for income taxes	153	(6,745)	6,898	102 %
Provision for (benefit from) income taxes	73	(2,343)	2,416	103 %
Net income (loss)	\$80	\$(4,402)	\$4,482	102 %

Revenues

Revenues were \$38.3 million for the three months ended March 31, 2016, a decrease of approximately 1%, compared to revenues of \$38.6 million for the three months ended March 31, 2015.

Student lending revenues were \$29.6 million for the three months ended March 31, 2016, representing an increase of \$2.6 million, or 10%, compared to the three months ended March 31, 2015. The increase was primarily a result of an increase in the number of borrowers that are participating in the rehabilitation programs with our Guaranty Agency clients, which was partially offset by the reduction of revenues from the Department of Education during the contract transition process and fixed fees associated with the income based repayment programs.

Healthcare revenues were \$2.7 million for the three months ended March 31, 2016, representing a decrease of \$2.6 million, or 48%, compared to the three months ended March 31, 2015. This decrease was due primarily to reduced

levels of permitted healthcare audit and recovery activities under our CMS RAC contract.

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Salaries and Benefits

Salaries and benefits expense was \$21.3 million for the three months ended March 31, 2016, a decrease of \$2.4 million, or 10%, compared to salaries and benefits expense of \$23.7 million for the three months ended March 31, 2015. The decrease in salaries and benefits expense was primarily due to a decrease in employee headcount.

Other Operating Expenses

Other operating expenses were \$14.4 million for the three months ended March 31, 2016, a decrease of \$4.8 million, or 25%, compared to other operating expenses of \$19.2 million for the three months ended March 31, 2015. The decrease in other operating expenses was primarily due to lower transaction expenses associated with a contemplated acquisition incurred in the first quarter of 2015.

Income (Loss) from Operations

Income from operations was \$2.6 million for the three months ended March 31, 2016, compared to a loss from operations of \$4.4 million for the three months ended March 31, 2015, representing an increase of \$6.9 million or 159%. The increase was primarily the result of lower other operating expenses, which was partially offset by lower revenues.

Interest Expense

Interest expense was \$2.4 million for the three months ended March 31, 2016, compared to \$2.4 million for the three months ended March 31, 2015. Interest expense increased slightly, due to a write off of unamortized debt issuance costs offset by lower interest expense from a lower loan principal balance.

Income Taxes

Income tax expense was \$0.1 million for the three months ended March 31, 2016, compared to an income tax benefit of \$2.3 million for the three months ended March 31, 2015. Our effective income tax rate increased to 47.7% for the three months ended March 31, 2016, from 34.7% for the three months ended March 31, 2015. The increase in the effective tax rate is primarily due to the income from operations generated in the three months ended March 31, 2016 compared to the loss from operations for the three months ended March 31, 2015 and the resulting impact of the discrete items on the effective tax rate.

Net Income (Loss)

As a result of the factors described above, net income was \$0.1 million for the three months ended March 31, 2016, which represented an increase of \$4.5 million, or 102% compared to net loss of \$4.4 million for the three months ended March 31, 2015.

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Adjusted EBITDA and Adjusted Net Income

To provide investors with additional information regarding our financial results, we have disclosed in the table below adjusted EBITDA and adjusted net income, both of which are non-GAAP financial measures. We have provided a reconciliation below of adjusted EBITDA to net income and adjusted net income to net income, the most directly comparable GAAP financial measure to these non-GAAP financial measures.

We have included adjusted EBITDA and adjusted net income in this report because they are key measures used by our management and board of directors to understand and evaluate our core operating performance and trends and to prepare and approve our annual budget. Accordingly, we believe that adjusted EBITDA and adjusted net income provide useful information to investors and analysts in understanding and evaluating our operating results in the same manner as our management and board of directors.

Our use of adjusted EBITDA and adjusted net income has limitations as an analytical tool, and you should not consider it in isolation or as a substitute for analysis of our results as reported under GAAP. Some of these limitations are:

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

adjusted EBITDA does not reflect interest expense on our indebtedness;

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

adjusted EBITDA does not reflect tax payments;

adjusted EBITDA and adjusted net income do not reflect the potentially dilutive impact of equity-based compensation; and

other companies may calculate adjusted EBITDA and adjusted net income differently than we do, which reduces its usefulness as a comparative measure.

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Because of these limitations, you should consider adjusted EBITDA and adjusted net income alongside other financial performance measures, including net income and our other GAAP results. The following tables present a reconciliation of adjusted EBITDA and adjusted net income for each of the periods indicated:

	Three Months Ended March 31, 2016 2015 (in thousands)	
Adjusted EBITDA:		
Net income (loss)	\$80	\$(4,402)
Provision for (benefit from) income taxes	73	(2,343)
Interest expense	2,432	2,385
Transaction expenses ⁽¹⁾	—	3,229
Restructuring and other expenses ⁽⁴⁾	232	696
Depreciation and amortization	3,390	3,542
Stock-based compensation	1,204	1,003
Adjusted EBITDA	\$7,411	\$4,110

	Three Months Ended March 31, 2016 2015 (in thousands)	
Adjusted Net Income:		
Net income (loss)	\$80	\$(4,402)
Transaction expenses ⁽¹⁾	—	3,229
Stock-based compensation	1,204	1,003
Amortization of intangibles ⁽²⁾	936	1,188
Deferred financing amortization costs ⁽³⁾	746	324
Restructuring and other expenses ⁽⁴⁾	232	696
Tax adjustments ⁽⁵⁾	(1,247)	(2,576)
Adjusted Net Income (Loss)	\$1,951	\$(538)

(1) Represents direct and incremental costs associated with expenses incurred in 2015 for a potential acquisition and related financing.

(2) Represents amortization of capitalized expenses related to the acquisition of Performant by an affiliate of Parthenon Capital Partners in 2004, and also an acquisition in the first quarter of 2012 to enhance our analytics capabilities.

(3) Represents amortization of capitalized financing costs related to financing conducted in 2012 and costs related to the amendment of the terms of the note payable in 2014 and 2016.

(4) Represents restructuring costs and severance and termination expenses incurred in connection with termination of employees and consultants.

(5) Represents tax adjustments assuming a marginal tax rate of 40%.

Liquidity and Capital Resources

Our primary source of liquidity is cash flows from operations. Cash and cash equivalents, which excludes restricted cash, totaled \$48.1 million as of March 31, 2016, and consists primarily of cash on deposit with banks. There are currently no borrowings outstanding under our revolving credit facility. There are \$2.0 million letters of credit which reduces our available line of credit of \$11.0 million. Due to our operating cash flows and our existing cash and cash equivalents and our ability to restructure both our variable and fixed expenses, we believe that we have the ability to meet our working capital and capital expenditure needs through the second quarter of 2017. See "Long-term Debt" below.

The \$23.1 million decrease in the balance of our cash and cash equivalents was primarily due to principal repayments of \$24.8 million on our long-term debt, and a \$7.5 million restricted cash deposit, both of which were made in connection with

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the amendment to our credit agreement completed on February 19, 2016, and \$1.8 million of capital expenditures partially offset by cash generated from operations of \$11.3 million.

Cash flows from operating activities

Cash provided by operating activities provided \$11.3 million for the three months ended March 31, 2016 was primarily due to a decrease in trade accounts receivable of \$4.7 million, an increase in accrued salaries and benefits of \$1.6 million and an increase in net payable to client of \$1.5 million.

Cash flows from investing activities

Cash used in investing activities of \$1.8 million for the three months ended March 31, 2016 was mainly for capital expenditures related to information technology, data storage, hardware, telecommunication systems and security enhancements to our proprietary software.

Cash flows from financing activities

Cash used in financing activities of \$32.6 million for the three months ended March 31, 2016 was primarily attributable to repayments of principal of \$24.8 million on long-term debt and a \$7.5 million deposit in restricted cash.

Restricted Cash

As of March 31, 2016, restricted cash included in current assets on our consolidated balance sheet was \$7.5 million. As discussed below, on February 19, 2016 the Company deposited \$7.5 million into a segregated deposit account in connection with the Fourth Amendment to our credit agreement. The cash in this segregated deposit account is restricted because it is subject to the exclusive control of the administrative agent as set forth in our credit agreement.

Estimated liability for appeals and net payable to client

The March 31, 2016 balances of \$19.1 million and \$15.9 million for the estimated liability for appeals and the net payable to client, respectively, represent obligations that we expect to pay in the near term, although it is difficult to predict the precise timing of the associated cash outflows as they are dependent on the processing and resolution of audit appeals.

Long-term Debt

On March 19, 2012, we, through our wholly owned subsidiary, entered into a \$147.5 million credit agreement, as amended and restated, with Madison Capital Funding LLC as administrative agent, ING Capital LLC as syndication agent, and other lenders party thereto. The senior credit facility consists of (i) a \$57.0 million term A loan that matures in March 2017, (ii) a \$79.5 million term B loan that matures in March 2018, and (iii) a \$11.0 million revolving credit facility that expires in March 2017. On June 28, 2012, we amended the credit agreement to increase the amount of our borrowings under our term B loan by \$19.5 million. On each of November 4, 2014, January 28, 2015, and February 19, 2016, we further amended the credit agreement to modify a number of existing covenants and add certain new covenants.

All borrowings under the credit agreement bear interest at a rate per annum equal to an applicable margin plus, at our option, either (i) a base rate determined by reference to the highest of (a) the prime rate published in the Wall Street Journal or another national publication, (b) the federal funds rate plus 0.5%, (c) the sum of (A) the 1-month LIBOR rate and (B) the difference between the then effective applicable margins for LIBOR loans and base rate loans and (d) 2.5% or (ii) a LIBOR rate determined by reference to the highest of (a) a LIBOR rate published in Reuters or another national publication and (b) 1.5%. The term A loan and the revolving credit facility have an applicable margin of 5.75% for base rate loans and 6.75% for LIBOR rate loans. The term B loan (including the incremental term B loan) has an applicable margin of 6.25% for base rate loans and 7.25% for LIBOR rate loans. Interest is due at the end of each month for base rate loans and at the end of each LIBOR period for LIBOR rate loans unless the LIBOR period is greater than 3 months, in which case interest is due at the last day of each 3-month interval of such LIBOR period. The lenders are not required to make new loans or issue new letters of credit under the revolving credit facility when the total debt to EBITDA ratio exceeds 3.25 to 1.0.

The credit agreement requires us to prepay the two term loans on a prorated basis and then to prepay the revolving credit facility under certain circumstances: (i) with 100% of the net cash proceeds of any asset sale or other disposition of assets by us or our subsidiaries where the net cash proceeds exceed \$1 million and (ii) with a percentage of our annual excess cash flow each year where such percentage ranges from 25%-75% depending on our total debt to EBITDA ratio reduced by any voluntary prepayments that are made on our term loans during the same period, unless

we elect to apply voluntary prepayments in the inverse order of maturity, in which case only voluntary prepayments in excess of \$10 million shall reduce the amount of excess cash flow we are required to prepay. With respect to (ii) above, in May 2015 and May 2014, the Company made

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payments of \$7.0 million and \$11.5 million, respectively, to the lenders. In addition, the Company made a prepayment of \$1.3 million to the lenders in July 2015 for the sale of land in San Angelo, TX.

We have to abide by certain negative covenants for our credit agreement, which limit the ability for our subsidiaries and us to:

- incur additional indebtedness;
- create or permit liens;
- pay dividends or other distributions to our equity holders;
- purchase or redeem certain equity interests of our equity holders, including any warrants, options and other security rights;
- pay management fees or similar fees to any of our equity holders;
- make any redemption, prepayment, defeasance, repurchase or any other payment with respect to any subordinated debt;
- consolidate, merge or make any acquisitions;
- sell assets, including the capital stock of our subsidiaries;
- enter into transactions with our affiliates;
- enter into different business lines;
- permit the aggregate amount of capital expenditures to exceed a certain amount; and
- make investments.

The credit agreement also requires us to meet certain financial covenants, including maintaining (i) a fixed charge coverage ratio, (ii) a total debt to EBITDA ratio, (iii) an interest coverage ratio, (iv) a minimum EBITDA amount, (v) a minimum required adjusted cash amount, and (vi) maximum capital expenditures, as such terms are defined in our credit agreement. These financial covenants are tested at the end of each year, quarter or month, as applicable. The table below further describes these financial covenants, as well as our current status under these covenants as of March 31, 2016.

Financial Covenant	Covenant Requirement	Actual Ratio at March 31, 2016
Fixed charge coverage ratio (minimum) ¹	N/A	N/A
Total debt to EBITDA ratio (maximum) ²	4.75 to 1.0	1.92
Interest coverage ratio (minimum) ³	2.5 to 1.0	4.42
EBITDA (minimum) ⁴	\$20,000,000	\$32,327,000
Required Adjusted Cash Amount (minimum)	\$10,000,000	\$26,636,000
Capital Expenditures ⁵	\$8,000,000	N/A

(1) The fixed charge coverage ratio will apply to the computation periods ending September 30, 2017, and each computation period thereafter.

(2) The total EBITDA ratio will adjust in future periods.

(3) The interest coverage ratio applies through computation period ending June 30, 2017 and will adjust in future periods.

(4) This requirement is effective through June 30, 2016.

(5) This requirement is an annual limitation and adjusts to \$8,000,000 for the years ending December 31, 2016 and December 31, 2017.

On February 19, 2016, we entered into amendment No. 4 to the credit agreement. Pursuant to the Fourth Amendment, our financial covenants were modified as follows:

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the annual capital expenditure limitation of \$12.5 million, which was in effect for the year ending December 31, 2016, has been revised to be \$8 million for the years ending December 31, 2016 and December 31, 2017;

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the total debt to EBITDA ratio of 3.25 to 1.0, which was in effect for the computation periods ending as of March 31, 2017 and June 30, 2017, has been revised to be 4.75 to 1.0 for those periods;

the interest coverage ratio of 2.50 to 1.0, which was in effect for the computation period ending as of December 31, 2016, has been revised to be 2.0 to 1.0 for the computation period ending as of December 31, 2016 and 1.75 to 1.0 for the computation periods ending as March 31, 2017 and June 30, 2017;

the fixed charge coverage ratio of 1.20 to 1.0, which was in effect for the quarterly computation periods under the credit agreement ending as of March 31, 2017 through December 31, 2017, has been revised to apply only to the computation periods ending as September 30, 2017 and December 31, 2017;

the required minimum adjusted cash balance of \$30.0 million, which was in effect from March 31, 2016 through December 31, 2016, has been revised to be \$10.0 million from March 31, 2016 through September 30, 2016; and

the minimum trailing twelve month EBITDA of \$20.0 million, which was in effect from March 31, 2016 through December 31, 2016, has been revised by shortening such period to extend until June 30, 2016.

In connection with the most recent amendment, we voluntarily prepaid \$22.5 million under the credit agreement, which was applied ratably to the Term A loan and the Term B loan. In addition, we deposited \$7.5 million into a deposit account which is subject to the exclusive control of the Agent. These funds will be remitted to the Agent for application to the term loans or other obligations, as applicable, under the credit agreement on the earlier to occur of (i) September 30, 2016 (or such later date not more than thirty (30) days thereafter as may be agreed by Agent in its sole discretion) and (ii) the occurrence and continuation of an event of default; however, all or a portion of these funds may also be returned to us if the Agent and the requisite lenders under the credit agreement elect otherwise in their sole discretion.

Due to delays in the award of the new contracts by CMS and the Department of Education, significant limitations on our audit and recovery activity during the CMS contract transition period, suspension of student loan placements to us from the Department of Education during the contract transition period and recovery fee reductions in the student lending market, we have been actively restructuring both our variable and fixed expenses consistent with our reduced operations and in order to maintain compliance with our debt covenants. Our current financial projections show that we expect to be able to maintain compliance with our covenants through the second quarter of 2017. However, the factors noted above have had and, until resolved, will continue to have a significant negative effect on our revenues and earnings and our ability to continue to comply with our covenants. Accordingly, we expect to seek further modifications to the covenants from our lenders or refinance our indebtedness. Our inability to maintain long-term compliance with our debt covenants, or to refinance or restructure the terms of our indebtedness on commercially reasonable terms or at all, would have an adverse effect, which could be material on our business, financial condition and results of operations, as well as our ability to satisfy our debt obligations.

In addition, due to the delays in the award of the new contracts from the Department of Education and CMS, we implemented cost and expense reductions during 2015 and the first quarter of 2016 that included a significant reduction in personnel. To the extent we are able to secure new contracts with the Department of Education or CMS, we will incur significant expenses to hire additional personnel that will be required to provide services under any such new contract that may require us to obtain additional financing. There can be no assurance that we will be able to obtain such financing on favorable terms, or at all.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

We do not hold or issue financial instruments for trading purposes. We conduct all of our business in U.S. currency and therefore do not have any material direct foreign currency risk. We do have exposure to changes in interest rates with respect to the borrowings under our senior secured credit facility, which bear interest at a variable rate based on the prime rate or LIBOR. For example, if the interest rate on our borrowings increased 100 basis points (1%) from the credit facility floor of 1.5%, our annual interest expense would increase by approximately \$0.7 million.

While we currently hold our excess cash in an operating account, in the future we may invest all or a portion of our excess cash in short-term investments, including money market accounts, where returns may reflect current interest rates. As a result, market interest rate changes impact our interest expense and interest income. This impact will depend on variables such as the magnitude of interest rate changes and the level of our borrowings under our credit

facility or excess cash balances.

ITEM 4. DISCLOSURE CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures

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We maintain “disclosure controls and procedures,” as such term is defined in Rule 13a-15(e) under the Securities Exchange Act of 1934, or the Exchange Act, that are designed to ensure that information required to be disclosed by us in reports that we file or submit under the Exchange Act is recorded, processed, summarized, and reported within the time periods specified in Securities and Exchange Commission rules and forms, and that such information is accumulated and communicated to our management, including our principal executive officer (our Chief Executive Officer) and our principal financial officer (our Chief Financial Officer), as appropriate, to allow timely decisions regarding required disclosure. In designing and evaluating our disclosure controls and procedures, management recognized that disclosure controls and procedures, no matter how well conceived and operated, can provide only reasonable assurance of achieving the desired control objectives.

Management, with the participation of our Chief Executive Officer and our Chief Financial Officer, has evaluated the effectiveness of our disclosure controls and procedures, as defined in Rule 13a-15(e) under the Exchange Act, as of the fiscal quarter covered by this Quarterly Report on Form 10-Q. Based on that evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were functioning effectively at the reasonable assurance level as of March 31, 2016.

Changes in Internal Control over Financial Reporting

There was no change in our internal control over financial reporting during the quarter ended March 31, 2016, that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

We are involved in various legal proceedings that arise from our normal business operations. These actions generally derive from our student loan recovery services, and generally assert claims for violations of the Fair Debt Collection Practices Act or similar federal and state consumer credit laws. While litigation is inherently unpredictable, we believe that none of these legal proceedings, individually or collectively, will have a material adverse effect on our financial condition or our results of operations.

ITEM 1A. RISK FACTORS

Our business, financial condition, results of operations and liquidity are subject to various risks and uncertainties, including those described below, and as a result, the trading price of our common stock could decline.

Risks Related to Our Business

Our agreements with the Department of Education and CMS, historically two of our most significant customers, are currently subject to rebidding processes, and our failure to renew these agreements or a renewal on less favorable terms would have a significant negative impact on our revenues and results of operations.

Our existing contracts with the Department of Education and CMS are currently subject to rebidding processes. The Department of Education and CMS were responsible for approximately 19.2% and 3.1% of our revenue for the quarter ended March 31, 2016, respectively and 23.8% and 7.8% of our revenue for the year ended December 31, 2015 respectively.

While five other recovery service providers have had their contracts extended by the Department of Education past the original April 2015 expiration date, we did not receive such an extension from the Department of Education. We submitted our proposal for a new contract to the Department of Education in February 2016, but it is uncertain as to when any new contracts will be awarded. We do not anticipate receiving any new loan placements from the Department of Education until the new contracts are awarded. Due to the timing of the rehabilitation process for loans placed with us by the Department of Education, there was a minimal impact on our revenues in 2015 as a result of not receiving an extension of our current contract. However, the absence of placements of new student loans from the Department of Education since the expiration of our prior contract in April 2015 will have a significant negative impact on our revenues in 2016 and beyond.

We are also currently participating in a competitive bidding process for the next RAC contract. The bidding process has been delayed by pre-award protests and litigation regarding certain payment terms that were proposed by CMS in the new RAC contract proposals. While we believe our performance under existing contracts with the Department of

Education and CMS and the experience we have gained in performing under these contracts position us well to renew both of these agreements, continued delays in the award of the new contracts, failure to retain either of these agreements or a significant

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adverse change in the terms of either of these agreements upon any renewal would seriously harm our revenues and our operating results and may cause us to not be in compliance with our debt covenants.

In addition, due to the delays in the award of the new contracts from the Department of Education and CMS, we implemented cost and expense reductions during 2015, that included a significant reduction in personnel. To the extent we are able to secure new contracts with the Department of Education or CMS, we will incur significant expenses to hire additional personnel that will be required to provide services under any such new contract that may require us to obtain additional financing. There can be no assurance that we will be able to obtain such financing on favorable terms, or at all. Further, if we obtain new contracts from the Department of Education or CMS, we expect there will be delays until we start to recognize revenues after such award is made.

Our current or future indebtedness could adversely affect our business and financial condition and reduce the funds available to us for other purposes, and our failure to comply with the covenants contained in our senior secured credit facility could result in an event of default that could jeopardize our financial condition.

As of March 31, 2016, our estimated total debt was \$69.5 million. In February 2016, in connection with an amendment to our credit agreement, we voluntarily prepaid \$22.5 million of the outstanding principal under our credit agreement. For the quarter ended March 31, 2016 our consolidated interest expense was \$2.4 million. Our ability to make scheduled payments or to refinance our debt obligations and to fund our other liquidity needs depends on our financial and operating performance. Due to factors such as our still unresolved contractual relationships with the Department of Education and CMS, we cannot make assurances that we will maintain a level of cash flows from operating activities sufficient to permit us to pay the principal and interest on our indebtedness and to fund our other liquidity needs. If our cash flows and capital resources are insufficient to fund our debt service obligations and allow us to maintain compliance with the financial covenants and other covenants under our senior secured credit facility or to fund our other liquidity needs, we may be forced to reduce or delay capital expenditures, sell assets or operations, seek additional capital or restructure or refinance our indebtedness. We cannot ensure that we would be able to take any of these actions, or that these actions would be successful and permit us to meet our scheduled debt service obligations. If we cannot make scheduled payments on our debt, we will be in default and, as a result, our debt holders could declare all outstanding principal and interest to be due and payable, our lenders could foreclose against the assets securing our borrowings and we could be forced into bankruptcy or liquidation.

Due to delays in the award of the new contracts by CMS and the Department of Education, significant limitations on our audit and recovery activity during the CMS contract transition period, suspension of student loan placements to us from the Department of Education during the contract transition period and recovery fee reductions in the student lending market, we have been actively restructuring both our variable and fixed expenses consistent with our reduced operations and in order to maintain compliance with our debt covenants. We also recently amended the covenants in our credit agreement as a result of our reduced operations. Our current financial projections show that we expect to be able to maintain compliance with our covenants through the second quarter of 2017. However, the factors noted above have had and, until resolved, will continue to have a significant negative effect on our revenues and earnings and our ability to continue to comply with our covenants. Accordingly, we expect that it will be necessary to seek further modifications to the covenants from our lenders or refinance our indebtedness. To the extent we are not able to maintain compliance with our covenants, relations with both our existing and future customers could be adversely affected. Our inability to maintain long-term compliance with our debt covenants, or to refinance or restructure the terms of our indebtedness on commercially reasonable terms or at all, would have a material adverse effect on our business, financial condition and results of operations, as well as our ability to satisfy our debt obligations.

Over the course of our existing RAC contract, there has been an increase in the number of appeals by healthcare providers to the third, or ALJ, level of appeal relating to claims we have audited, and there can be no assurance that our estimated liability for such appeals will be adequate.

Under our RAC contract with CMS, we recognize revenues when the healthcare provider has paid CMS for a claim or has agreed to an offset against other claims by the provider. Healthcare providers have the right to appeal a claim and may pursue additional levels of appeal if the initial appeal is found in favor of CMS. We accrue an estimated liability for appeals at the time revenue is recognized based on our estimate of the amount of revenue probable of being refunded to CMS following successful appeal based on historical data and other trends relating to such appeals. In

addition, if our estimate of liability for appeals with respect to revenues recognized during a prior period changes, we increase or decrease the estimated liability reserve in the current period. Over the course of our existing RAC contract, healthcare providers have increased their pursuit of appeals beyond the first and second levels of appeal to the third level of appeal, where cases are heard by administrative law judges, or ALJs. In our experience, decisions at the third level of appeal are the least favorable as ALJs exercise greater discretion and there is less predictability in the ALJ decisions as compared to appeals at the first or second levels. The pursuit of third level appeals by healthcare providers has also resulted in a backlog of claims at that level of appeal. This increase of ALJ appeals and backlog of claims at the third level of appeal is the primary reason our total estimated liability for appeals

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(consisting of the estimated liability for appeals plus the contra-accounts-receivable estimated allowance for appeals) has grown from a balance of \$16.4 million at December 31, 2013 to \$18.6 million as of December 31, 2014 to \$19.0 million as of December 31, 2015, and decreased to \$18.9 million as of March 31, 2016. Our estimates for our appeal reserve are subject to uncertainties, and accordingly we may underestimate the number of successful appeals or the financial impact of successful appeals in a given year or period. To the extent that the amount of commissions that we are required to return to CMS as a result of successful appeals exceeds our estimated appeals reserve, our revenues in the applicable period will be reduced by the amount of such excess. If we underestimate the amount of commissions that are subject to successful appeal, our revenues in future periods could be adversely affected. In addition, each of the subcontractors we engaged to assist in the recovery services under our RAC contract are similarly obligated to refund fees that they received from claims that are later overturned on appeal. To the extent any of our subcontractors fail to refund amounts that are due upon an appeals relating to claim that they were responsible for, we may be obligated to pay such amounts directly to CMS, which could have a material impact on our financial position. Further, in August 2014 CMS offered to pay hospitals 68% of what they have billed Medicare to settle a backlog of pending appeals challenging Medicare's denials of reimbursement for certain types of short term care. The implication of this settlement offer related to claims for which recovery auditors have already been paid under existing RAC contracts remains uncertain at this time. Any payments we are required to make to CMS under our existing RAC contract in connection with such settlement offer may be significant and in excess of the amount we have reserved for appeals, which could have a material negative impact our financial position and liquidity.

The transition rules implemented by CMS in connection with the award of the new RAC contracts and the delays associated with the award of the new RAC contract will have an adverse impact on our revenues.

Our ability to make claims under our existing RAC contract continues to be limited by contract transition rules announced by CMS. During 2015 and 2016, our audit and recovery activities under the RAC contract were entirely suspended or subject to significant restrictions. Such restrictions involve limitations on the types of claims and the amount of medical records requests that we may make, and CMS has generally maintained a long running prohibition on requesting medical records from PIP providers. These transition rules had a material adverse effect on our revenues during the three months ended March 31, 2016. Our revenues from CMS during the three months ended March 31, 2016 were \$1.2 million compared to \$3.2 million during the same period in 2015. In addition, the bidding process for the new RAC contracts has been delayed by pre-award protests and litigation regarding certain payment terms that were proposed by CMS in the new RAC contract proposals. As a result of these protests and litigation, on June 2, 2015, CMS announced it had withdrawn requests for bids for the new RAC contracts under the original statement of work proposals and released a new RFP which we are in process of responding to. As a result of the delays in the award of the new RAC contract and the restrictions on our audit activities under the existing contract, reduction in healthcare revenues had a material adverse effect on our revenues for 2015 and we expect this reduction in revenues will continue in 2016. In addition, if we are successful in obtaining a new RAC contract with CMS, we expect there will be an approximate four to six month period until we start to recognize revenue under a new RAC contract after the award is made.

Revenues generated from our three largest clients represented 57% of our revenues for the quarter ended March 31, 2016, and 55% of our revenues for the year ended December 31, 2015, and any termination of or deterioration in our relationship with any of these clients would result in a decline in our revenues.

We derive a substantial majority of our revenues from a limited number of clients, including the Department of Education, CMS and several GAs. Revenues from our three largest clients represented 57% of our revenues for the quarter ended March 31, 2016 and 55% of our revenues for the year ended December 31, 2015. All of our contracts with these clients are subject to periodic renewal and re-bidding processes and if we lose one of these clients or if the terms of our relationships with any of these clients become less favorable to us, our revenues would decline, which would harm our business, financial condition and results of operations.

Many of our contracts with our clients for the recovery of student loans and other receivables are not exclusive and do not commit our clients to provide specified volumes of business. In addition, the terms of these contracts may be changed unilaterally and on short notice by our clients. As a consequence, there is no assurance that we will be able to maintain our revenues and operating results.

Substantially all of our existing contracts for the recovery of student loans and other receivables, which represented approximately 93% of our revenues for the three months ended March 31, 2016 and 88% of our revenues in the year ended December 31, 2015, enable our clients to unilaterally terminate their contractual relationship with us at any time without penalty, potentially leading to loss of business or renegotiation of terms. Further, most of our contracts in these markets allow our clients to unilaterally change the volume of loans and other receivables that are placed with us or the payment terms at any

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given time. In addition, most of our contracts are not exclusive, with our clients retaining multiple service providers with whom we must compete for placements of loans or other obligations. Therefore, despite our contractual relationships with our clients, our contracts do not provide assurance that we will generate a minimum amount of revenues or that we will receive a specific volume of placements.

Our revenues and operating results would be negatively affected if our student loan and receivables clients, which include four of our five largest clients in 2016 and 2015, reduce the volume of student loan placements provided to us, modify the terms of service, including the success fees we are able to earn upon recovery of defaulted student loans, or any of these clients establish more favorable relationships with our competitors. For example, in 2013 in connection with the Department of Education's decision to have its recovery vendors promote income based repayment, or IBR, to defaulted student loans, the Department of Education unilaterally reduced the contingency fee rate that we receive for rehabilitating student loans by approximately 13%. Further, effective July 1, 2015, the Department of Education implemented a fixed fee of \$1,710 payable for each loan that is rehabilitated in place of a recovery fee that historically had been based on a percentage of the balance of the rehabilitated loan.

Our ability to derive revenues under our RAC contract will depend in part on the number and types of potentially improper claims that we are allowed to pursue by CMS, and our results of operations may be harmed if the scope of claims that we are allowed to pursue and be compensated for is limited.

Under our existing RAC contract with CMS and any new RAC contract that we enter into upon completion of the current rebidding process with CMS, we are not permitted to and may not seek the recovery of an improper claim unless that particular type of claim has been pre-approved by CMS to ensure compliance with applicable Medicare payment policies, as well as national and local coverage determinations. Accordingly, the long-term growth of the revenues we derive under a RAC contract will also depend in part on CMS expanding the scope of potentially improper claims that we are allowed to pursue. If we are unable to continue to identify improper claims within the types of claims that we are permitted to pursue from time to time or if CMS does not expand the scope of potentially improper claims that we are allowed to pursue, our results of operations could be adversely affected.

In addition, CMS has implemented rules that prevent RAC contractors from being able to review and audit (i) whether inpatient care delivered to patients with hospital stays lasting less than two midnights was medically necessary and therefore deserving of the higher reimbursement levels under Medicare Part A or (ii) whether inpatient treatment was medically necessary for admissions spanning more than two midnights. In connection with these restrictions, hospitals cannot bill CMS for outpatient services on hospital stays lasting less than two midnights during such period. Fees associated with recoveries initiated by us based upon improper claims for inpatient reimbursement of these short stays have represented a substantial portion of the revenues we have earned under our existing RAC contract. The continued suspension of this type of review activity could have a material adverse effect on our future healthcare revenues and operating results in the event we are successful in obtaining a second RAC contract, depending on a variety of factors including, among other things, CMS's evaluation of provider compliance with the new rules, the rules ultimately adopted by CMS with respect to medical necessity reviews of Medicare reimbursement claims associated with short stay inpatient admissions and, more generally, the scope of improper claims that CMS allows us to pursue and our ability to successfully identify improper claims within the permitted scope. In connection with the award of the new RAC contract, CMS has indicated that it is reviewing certain aspects of the RAC contract including the amount of medical records that RAC vendors may request and the timeframes for review and communications between RAC vendors and providers.

We face significant competition in connection with obtaining, retaining and performing under our existing client contracts, including our contracts with the Department of Education and CMS, and an inability to compete effectively in the future could harm our relationships with our clients, which would impact our ability to maintain our revenues and operating results.

We operate in very competitive markets. In providing our services to the student loan and other receivables markets, we face competition from many other companies. Initially, we compete with these companies to be one of typically several firms engaged to provide recovery services to a particular client and, if we are successful in being engaged, we

then face continuing competition from the client's other retained firms based on the client's benchmarking of the recovery rates of its several vendors. In addition, those recovery vendors who produce the highest recovery rates from a client often will be allocated additional placements and in some cases additional success fees. Accordingly, maintaining high levels of recovery performance, and doing so in a cost-effective manner, are important factors in our ability to maintain and grow our revenues and net income and the failure to achieve these objectives could harm our business, financial condition and results of operations. Some of our current and potential competitors in the markets in which we operate may have greater financial, marketing, technological or other resources than we do. The ability of any of our competitors and potential competitors to adopt new and effective technology to better serve our markets may allow them to gain market strength. Increasing levels of

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competition in the future may result in lower recovery fees, lower volumes of contracted recovery services or higher costs for resources. Any inability to compete effectively in the markets that we serve could adversely affect our business, financial condition and results of operations.

The U.S. federal government accounts for a significant portion of our revenues, and any loss of business from, or change in our relationship with, the U.S. federal government would result in a significant decrease in our revenues and operating results.

We have historically derived and are likely to continue to derive a significant portion of our revenues from the U.S. federal government. For the quarter ended March 31, 2016, revenues under contracts with the U.S. federal government accounted for approximately 26% of our total revenues, compared to 35% for the year ended December 31, 2015. In addition, fees payable by the U.S. federal government are expected to become a larger percentage of our total revenues over the next several years as a result of legislation that has transferred responsibility for all new student loan origination to the Department of Education. The continuation and exercise of renewal options on existing government contracts and any new government contracts are, among other things, contingent upon the availability of adequate funding for the applicable federal government agency. Changes in federal government spending could directly affect our financial performance.

For example, the Bipartisan Budget Act of 2013 reduced the compensation paid to GAs for the rehabilitation of student loans, effective July 1, 2014. This “revenue enhancement” measure reduced from 18.5% to 16.0% of the outstanding loan balance, the amount that GAs can charge borrowers when a rehabilitated loan is sold by the GA and eliminated entirely the GAs retention of 18.5% of the outstanding loan balance as a fee for rehabilitation services. The reduction in compensation the GAs receive resulted in a decrease of approximately 25.0% in the contingency fee percentage that we receive from the GAs for assisting in the rehabilitation of defaulted student loans. Further, on July 1, 2015, the Department of Education implemented a new fee structure with respect to payment for rehabilitated loans to provide a fixed fee of \$1,710 payable for each loan that is rehabilitated in place of a recovery fee that historically had been based as a percentage of the balance of the rehabilitated loan. Any additional decrease in the student loan contingency fees would result in a further decrease of our revenues. Further, any amounts that we may be obligated to pay CMS under existing RAC contract as a result of CMS’s offer to pay hospitals 68% of what they have billed Medicare to settle a backlog of pending appeals challenging Medicare’s denials of reimbursement for certain types of short term care could have a material negative impact our financial position and liquidity. The loss of business from the U.S. federal government, or significant policy changes or financial pressures within the agencies of the U.S. federal government that we serve would result in a significant decrease in our revenues, which would adversely affect our business, financial condition and results of operations.

Future legislative or regulatory changes affecting the markets in which we operate could impair our business and operations.

The two principal markets in which we provide our recovery services, government-supported student loans and the Medicare program, are a subject of significant legislative and regulatory focus and we cannot anticipate how future changes in government policy may affect our business and operations. For example, SAFRA significantly changed the structure of the government-supported student loan market by assigning responsibility for all new government-supported student loan originations to the Department of Education, rather than originations by private institutions and backed by one of 30 government-supported GAs. This legislation, and any future changes in the legislation and regulations that govern these markets, may require us to adapt our business to the new circumstances and we may be unable to do so in a manner that does not adversely affect our business and operations.

Our business relationship with the Department of Education has accounted for a significant portion of our revenues and will take on increasing importance to our business as a result of SAFRA. Our failure to maintain this relationship would significantly decrease our revenues.

While the majority of our historical revenues from the student loan market have come from our relationships with the GAs, as a result of SAFRA, the Department of Education will ultimately become the sole source of revenues in this market, although the GAs will continue to service their existing student loan portfolios for many years to come. As a

result, over time, and assuming we are successful in entering into a new contract with the Department of Education under the current rebidding process, defaults on student loans originated by the Department of Education will predominate and our ability to maintain the revenues we had previously received from a number of GA clients will depend on our relationship with a single client, the Department of Education. While we have 25 years of experience in performing student loan recovery services for the Department of Education, we were one of 17 unrestricted recovery service providers on the prior Department of Education contract. We are currently subject to a competitive rebidding process for the next contract with the Department of Education. While five other recovery service providers have had their contracts extended by the Department of Education past the original April 2015 expiration date, we did not receive such an extension from the Department of Education. We do not anticipate

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receiving any new loan placements from the Department of Education until the new contracts are awarded. If our relationship with the Department of Education terminates or deteriorates or if the Department of Education, ultimately as the sole holder of defaulted student loans, requires its contractors to agree to less favorable terms, our revenues would significantly decrease, and our business, financial condition and results of operations would be harmed.

We could lose clients as a result of consolidation among the GAs, which would decrease our revenues.

As a result of SAFRA, which terminated the ability of the GAs to originate government-supported student loans, some have speculated that there may be consolidation among the remaining GAs. This speculation has heightened as a result of the reduction of fees that the GAs will receive for rehabilitating student loans as a result of the Bipartisan Budget Act of 2013. If GAs that are our clients are combined with GAs with whom we do not have a relationship, we could suffer a loss of business. Two of our GA clients were each responsible for more than 10% of our total revenues in the the three months ended March 31, 2016 and the year ended December 31, 2015. The consolidation of our GA clients with others and the failure to provide recovery services to the consolidated entity could decrease our revenues, which could negatively impact our business, financial condition and results of operations.

Our results of operations may fluctuate on a quarterly or annual basis and cause volatility in the price of our stock. Our revenues and operating results could vary significantly from period-to-period and may fail to match our past performance because of a variety of factors, some of which are outside of our control. Any of these factors could cause the price of our common stock to fluctuate. Factors that could contribute to the variability of our operating results include:

- the amount of defaulted student loans and other receivables that our clients place with us for recovery;
- the timing of placements of student loans and other receivables which are entirely in the discretion of our clients;
- the schedules of government agencies for awarding contracts including the impact of any protests filed in connection with the award of any such contracts;
- our ability to successfully identify improper Medicare claims and the number and type of potentially improper claims that CMS authorizes us to pursue under our RAC contact;
- the loss or gain of significant clients or changes in the contingency fee rates or other significant terms of our business arrangements with our significant clients;
- technological and operational issues that may affect our clients and regulatory changes in the markets we service; and
- general industry and macroeconomic conditions.

Downturns in domestic or global economic conditions and other macroeconomic factors could harm our business and results of operations.

Various macroeconomic factors influence our business and results of operations. These include the volume of student loan originations in the United States, together with tuition costs and student enrollment rates, the default rate of student loan borrowers, which is impacted by domestic and global economic conditions, rates of unemployment and similar factors, and the growth in Medicare expenditures resulting from changes in healthcare costs. For example, during the global financial crisis beginning in 2008, the market for securitized student loan portfolios was disrupted, resulting in delays in the ability of some GA clients to resell rehabilitated student loans and, as a result, delays our ability to recognize revenues from these rehabilitated loans. Changes in the overall economy could lead to a reduction in overall recovery rates by our clients, which in turn could adversely affect our business, financial condition and results of operations.

We may not be able to manage our growth effectively and our results of operations could be negatively affected. Our business has expanded significantly, especially in recent years with the expansion of our services in the healthcare market, and we intend to maintain our focus on growth. However, our continued focus on growth and the expansion of our business may place additional demands on our management, operations and financial resources and will require us to incur additional expenses. We cannot be sure that we will be able to manage our growth effectively. In order to successfully manage our growth, our expenses will increase to recruit, train and manage additional qualified employees and subcontractors and to expand and enhance our administrative infrastructure and continue to improve our management, financial and information systems and controls. If we cannot manage our growth effectively, our expenses may increase and our results of operations could be negatively affected.

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A failure of our operating systems or technology infrastructure, or those of our third-party vendors and subcontractors, could disrupt the operation of our business.

A failure of our operating systems or technology infrastructure, or those of our third-party vendors and subcontractors, could disrupt our operations. Our operating systems and technology infrastructure are susceptible to damage or interruption from various causes, including acts of God and other natural disasters, power losses, computer systems failures, Internet and telecommunications or data network failures, operator error, computer viruses, losses of and corruption of data and similar events. The occurrence of any of these events could result in interruptions, delays or cessations in service to our clients, reduce the attractiveness of our recovery services to current or potential clients and adversely impact our financial condition and results of operations. While we have backup systems in many of our operating facilities, an extended outage of utility or network services may harm our ability to operate our business. Further, the situations we plan for and the amount of insurance coverage we maintain for losses as result of failures of our operating systems and infrastructure may not be adequate in any particular case.

If our security measures are breached or fail and unauthorized access is obtained to our clients' confidential data, our services may be perceived as insecure, the attractiveness of our recovery services to current or potential clients may be reduced, and we may incur significant liabilities.

Our recovery services involve the storage and transmission of confidential information relating to our clients and their customers, including health, financial, credit, payment and other personal or confidential information. Although our data security procedures are designed to protect against unauthorized access to confidential information, our computer systems, software and networks may be vulnerable to unauthorized access and disclosure of our clients' confidential information. Further, we may not effectively adapt our security measures to evolving security risks, address the security and privacy concerns of existing or potential clients as they change over time, or be compliant with federal, state, and local laws and regulations with respect to securing confidential information. Unauthorized access to confidential information relating to our clients and their customers could lead to reputational damage which could deter our clients and potential clients from selecting our recovery services, or result in termination of contracts with those clients affected by any such breach, regulatory action, and claims against us.

In the event of any unauthorized access to personal or other confidential information, we may be required to expend significant resources to investigate and remediate vulnerabilities in our security procedures, and we may be subject to fines, penalties, litigation costs, and financial losses that are either not insured against or not fully covered through any insurance maintained by us. If one or more of such failures in our security and privacy measures were to occur, our business, financial condition and results of operations could suffer.

Our business may be harmed if we lose members of our management team or other key employees.

We are highly dependent on members of our management team and other key employees and our future success depends in part on our ability to retain these people. Our inability to continue to attract and retain members of our management team and other key employees could adversely affect our business, financial condition and results of operations.

The growth of our healthcare business will require us to hire and retain employees with specialized skills and failure to do so could harm our ability to grow our business.

The growth of our healthcare business will depend in part on our ability to recruit, train and manage additional qualified employees. Our healthcare-related operations require us to hire registered nurses and experts in Medicare coding. Finding, attracting and retaining employees with these skills is a critical component of providing our healthcare-related recovery and audit services, and our inability to staff these operations appropriately represents a risk to our healthcare service offering and associated revenues. An inability to hire qualified personnel, particularly to serve our healthcare clients, may restrain the growth of our business.

We rely on subcontractors to provide services to our clients and the failure of subcontractors to perform as expected could harm our business operations and our relationships with our clients.

We engage subcontractors to provide certain services to our clients. These subcontractors participate to varying degrees in our recovery activities with regards to all of the services we provide. While most of our subcontractors provide specific services to us, we have historically engaged one subcontractor to provide all of the audit and recovery services under our contract with CMS within a portion of our region. In a contract amendment executed in December

2015 we assumed responsibility over their portion in our region. While we believe that we perform appropriate due diligence before we hire subcontractors, our subcontractors may not provide adequate service or otherwise comply with the terms set forth in their agreements. In the event a subcontractor provides deficient performance to one or more of our clients, any such client may

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reduce the volume of services we are providing under an existing contract or may terminate the relevant contract entirely and we may face claims for breach of contract. Any such disruption in our relations with our clients as a result of services provided by any of our subcontractors could adversely affect our revenues and operating results.

If our software vendors or utility and network providers fail to deliver or perform as expected our business operations could be adversely affected.

Our recovery services depend in part on third-party providers, including software vendors and utility and network providers. Our ability to service our clients depends on these third-party providers meeting our expectations and contractual obligations in a timely and effective manner. Our business could be materially and adversely affected, and we might incur significant additional liabilities, if the services provided by these third-party providers do not meet our expectations or if they terminate or refuse to renew their relationships with us on similar contractual terms.

We are subject to extensive regulations regarding the use and disclosure of confidential personal information and failure to comply with these regulations could cause us to incur liabilities and expenses.

We are subject to a wide array of federal and state laws and regulations regarding the use and disclosure of confidential personal information and security. For example, the federal Health Insurance Portability and Accountability Act of 1996, as amended, or HIPAA, and related state laws subject us to substantial restrictions and requirements with respect to the use and disclosure of the personal health information that we obtain in connection with our audit and recovery services under our contract with CMS and we must establish administrative, physical and technical safeguards to protect the confidentiality of this information. Similar protections extend to the type of personal financial and other information we acquire from our student loan, state tax and federal receivables clients.

We are required to notify affected individuals and government agencies of data security breaches involving protected health and certain personally identifiable information. These laws and regulations also require that we develop, implement and maintain written, comprehensive information security programs containing safeguards that are appropriate to protect personally identifiable information or health information against unauthorized access, misuse, destruction or modification. Federal law generally does not preempt state law in the area of protection of personal information, and as a result we must also comply with state laws and regulations. Regulation of privacy, data use and security requires that we incur significant expenses, which could increase in the future as a result of additional regulations, all of which adversely affects our results of operations. Failure to comply with these laws and regulations can result in penalties and in some cases expose us to civil lawsuits.

Our student loan recovery business is subject to extensive regulation and consumer protection laws and our failure to comply with these regulations and laws may subject us to liability and result in significant costs.

Our student loan recovery business is subject to regulation and oversight by various state and federal agencies, particularly in the area of consumer protection. The Fair Debt Collection Practices Act, or FDCPA, and related state laws provide specific guidelines that we must follow in communicating with holders of student loans and regulates the manner in which we can recover defaulted student loans. Some state attorney generals have been active in this area of consumer protection regulation. We are subject, and may be subject in the future, to inquiries and audits from state and federal regulators, as well as frequent litigation from private plaintiffs regarding compliance under the FDCPA and related state regulations. We are also subject to the Fair Credit Reporting Act, or FCRA, which regulates consumer credit reporting and may impose liability on us to the extent adverse credit information reported to a credit bureau is false or inaccurate. Our compliance with the FDCPA, FCRA and other federal and state regulations that affect our student loan recovery business may result in significant costs, including litigation costs. We may also become subject to regulations promulgated by the United States Consumer Financial Protection Bureau, or CFPB, which was established in July 2011 as part of the Dodd-Frank Act to, among other things, establish regulations regarding consumer financial protection laws. In addition, the CFPB has investigatory and enforcement authority with respect to whether persons are engaged in unlawful acts or practices in connection with the collection of consumer debts.

In addition, changing laws, regulations and standards relating to corporate governance and public disclosure are creating uncertainty for public companies, increasing legal and financial compliance costs and making some activities more time consuming. These laws, regulations and standards are subject to varying interpretations, in many cases due to their lack of specificity, and, as a result, their application in practice may evolve over time as new guidance is

provided by regulatory and governing bodies. This could result in continuing uncertainty regarding compliance matters and higher costs necessitated by ongoing revisions to disclosure and governance practices. We will continue to invest resources to comply with evolving laws, regulations and standards, and this investment may result in increased general and administrative expenses and a diversion of management's time and attention from revenue-generating activities to compliance activities. If our efforts to comply with new laws, regulations and standards differ from the activities intended by regulatory or governing bodies due to ambiguities related

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to their application and practice, regulatory authorities may initiate legal proceedings against us and our business may be adversely affected.

However, for as long as we remain an “emerging growth company” as defined in the Jumpstart Our Business Startups Act of 2012, or the JOBS Act, we may take advantage of certain exemptions from various reporting requirements that are applicable to other public companies that are not “emerging growth companies,” including, but not limited to, not being required to comply with the auditor attestation requirements of Section 404 of the Sarbanes-Oxley Act, reduced disclosure obligations regarding executive compensation in our periodic reports and proxy statements, and exemptions from the requirements of holding a nonbinding advisory vote on executive compensation and shareholder approval of any golden parachute payments not previously approved. We may take advantage of these reporting exemptions until we are no longer an “emerging growth company.”

We will remain an “emerging growth company” for up to five years following our initial public offering in August 2012, although if the market value of our common stock that is held by non-affiliates exceeds \$700 million as of any June 30 before that time, our revenues exceed \$1 billion, or we issue more than \$1 billion in non-convertible debt in a three-year period, we would cease to be an “emerging growth company” as of the following December 31.

As a result of disclosure of information as a public company, our business and financial condition have become more visible, which we believe may result in threatened or actual litigation, including by competitors and other third parties. If such claims are successful, our business operations and financial results could be adversely affected, and even if the claims do not result in litigation or are resolved in our favor, these claims, and the time and resources necessary to resolve them, could divert the resources of our management and adversely affect our business operations and financial results. These factors could also make it more difficult for us to attract and retain qualified employees, executive officers and members of our board of directors.

Failure to achieve and maintain effective internal controls in accordance with Section 404 of Sarbanes-Oxley would impair our ability to produce accurate and reliable financial statements, which would harm our stock price.

We are subject to reporting obligations under Section 404 of the Sarbanes-Oxley Act that require us to include a management report on our internal control over financial reporting in our annual report, which contains management’s assessment of the effectiveness of our internal control over financial reporting. These requirements first applied to our annual report on Form 10-K for the year ended December 31, 2013 and complying with these requirements can be difficult. For example, in June 2012, we determined that we had incorrectly accounted for our mandatorily redeemable preferred stock, which required audit adjusting entries for the three-year period ended December 31, 2011. Our failure to detect this error was deemed to be a deficiency in internal control and this deficiency was considered to be a material weakness. To address this situation, our independent registered public accounting firm recommended that the Company emphasize the importance of thoroughly researching all new accounting policies and revisiting accounting policies set for existing transactions when changes in the business or reporting requirements occur or are expected to occur. To prevent issues like these in the future, we have bolstered our technical accounting expertise and, where appropriate, engaged outside consultants with specialized knowledge.

Our management may conclude that our internal control over our financial reporting is not effective. We have limited accounting personnel and other resources with which to address our internal controls and procedures. If we fail to timely achieve and maintain the adequacy of our internal control over financial reporting, we may not be able to produce reliable financial reports or help prevent fraud. Our failure to achieve and maintain effective internal control over financial reporting could prevent us from filing our periodic reports on a timely basis, which could result in the loss of investor confidence in the reliability of our financial statements, harm our business and negatively impact the trading price of our common stock.

We are required to disclose changes made in our internal controls and procedures on a quarterly basis. However, our independent registered public accounting firm is not required to formally attest to the effectiveness of our internal control over financial reporting pursuant to Section 404 until such time that we are no longer an “emerging growth company” as defined in the JOBS Act, if we continue to take advantage of the exemptions contained in the JOBS Act. At such time, our independent registered public accounting firm may issue a report that is adverse in the event it is not satisfied with the level at which our controls are documented, designed or operating. Our remediation efforts may not enable us to avoid a material weakness in the future.

Litigation may result in substantial costs of defense, damages or settlement, any of which could subject us to significant costs and expenses.

We are party to lawsuits in the normal course of business, particularly in connection with our student loan recovery services. For example, we are regularly subject to claims that we have violated the guidelines and procedures that must be followed under federal and state laws in communicating with consumer debtors. We may not ultimately prevail or otherwise be

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able to satisfactorily resolve any pending or future litigation, which may result in substantial costs of defense, damages or settlement. In the future, we may be required to alter our business practices or pay substantial damages or settlement costs as a result of litigation proceedings, which could adversely affect our business operations and results of operations.

We typically face a long period to implement a new contract which may cause us to incur expenses before we receive revenues from new client relationships.

If we are successful in obtaining an engagement with a new client or a new contract with an existing client, we typically have a subsequent long implementation period in which the services are planned in detail and we integrate our technology, processes and resources with the client's operations. If we enter into a contract with a new client, we typically will not receive revenues until implementation is completed and work under the contract actually begins. Our clients may also experience delays in obtaining approvals or delays associated with technology or system implementations, such as the delays experienced with the implementation of our RAC contract with CMS due to an appeal by competitors who were unsuccessful in bidding on the contract. Because we generally begin to hire new employees to provide services to a new client once a contract is signed, we may incur significant expenses associated with these additional hires before we receive corresponding revenues under any such new contract. If we are not successful in maintaining contractual commitments after the expenses we incur during our typically long implementation cycle, our results of operations could be adversely affected.

If we are unable to adequately protect our proprietary technology, our competitive position could be harmed or we could be required to incur significant costs to enforce our rights.

The success of our business depends in part upon our proprietary technology platform. We rely on a combination of copyright, patent, trademark, and trade secret laws, as well as on confidentiality procedures and non-compete agreements, to establish and protect our proprietary technology rights. The steps we have taken to deter misappropriation of our proprietary technology may be insufficient to protect our proprietary information. In particular, we may not be able to protect our trade secrets, know how and other proprietary information adequately. Although we use reasonable efforts to protect this proprietary information and technology, our employees, consultants and other parties may unintentionally or willfully disclose our information or technology to competitors. Enforcing a claim that a third party illegally obtained and is using any of our proprietary information or technology is expensive and time consuming, and the outcome is unpredictable. We rely, in part, on non disclosure, confidentiality and invention assignment agreements with our employees, consultants and other parties to protect our trade secrets, know how and other intellectual property and proprietary information. These agreements may not be self executing, or they may be breached and we may not have adequate remedies for such breach. Moreover, third parties may independently develop similar or equivalent proprietary information or otherwise gain access to our trade secrets, know how and other proprietary information. Any infringement, misappropriation or other violation of our patents, trademarks, copyrights, trade secrets, or other intellectual property rights could adversely affect any competitive advantage we currently derive or may derive from our proprietary technology platform and we may incur significant costs associated with litigation that may be necessary to enforce our intellectual property rights.

Claims by others that we infringe their intellectual property could force us to incur significant costs or revise the way we conduct our business.

Our competitors protect their proprietary rights by means of patents, trade secrets, copyrights, trademarks and other intellectual property. Any party asserting that we infringe, misappropriate or violate their intellectual property rights may force us to defend ourselves, and potentially our clients, against the alleged claim. These claims and any resulting lawsuit, if successful, could be time-consuming and expensive to defend, subject us to significant liability for damages or invalidation of our proprietary rights, prevent us from operating all or a portion of our business or force us to redesign our services or technology platform or cause an interruption or cessation of our business operations, any of which could adversely affect our business and operating results. In addition, any litigation relating to the infringement of intellectual property rights could harm our relationships with current and prospective clients. The risk of such claims and lawsuits could increase if we increase the size and scope of our services in our existing markets or expand into new markets.

We may make acquisitions that prove unsuccessful, strain or divert our resources and harm our results of operations and stock price.

We may consider acquisitions of other companies in our industry or in new markets. We may not be able to successfully complete any such acquisition and, if completed, any such acquisition may fail to achieve the intended financial results. We may not be able to successfully integrate any acquired businesses with our own and we may be unable to maintain our standards, controls and policies. Further, acquisitions may place additional constraints on our resources by diverting the attention of our management from other business concerns. Moreover, any acquisition may result in a potentially dilutive

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issuance of equity securities, the incurrence of additional debt and amortization of expenses related to intangible assets, all of which could adversely affect our results of operations and stock price.

The price of our common stock could be volatile, and you may not be able to sell your shares at or above the public offering price.

Since our initial public offering in August 2012, the price of our common stock, as reported by NASDAQ Global Select Market, has ranged from a low sales price of \$1.51 on March 24, 2016 to a high sales price of \$14.09 on March 4, 2013. The trading price of our common stock may be significantly affected by various factors, including: quarterly fluctuations in our operating results; the financial projections we may provide to the public, any changes in those projections or our failure to meet those projections; changes in investors' and analysts' perception of the business risks and conditions of our business; our ability to meet the earnings estimates and other performance expectations of financial analysts or investors; unfavorable commentary or downgrades of our stock by equity research analysts; changes in our capital structure, such as future issuances of debt or equity securities; lawsuits threatened or filed against us; strategic actions by us or our competitors, such as acquisitions or restructurings; new legislation or regulatory actions; changes in our relationship with any of our significant clients; fluctuations in the stock prices of our peer companies or in stock markets in general; and general economic conditions.

Our significant stockholders have the ability to influence significant corporate activities and our significant stockholders' interests may not coincide with yours.

Parthenon Capital Partners and Invesco Ltd. beneficially owned approximately 27.0% and 19.3% of our common stock, respectively, as of March 31, 2016. As a result of their ownership, Parthenon Capital Partners and Invesco Ltd. have the ability to influence the outcome of matters submitted to a vote of stockholders and, through our board of directors, the ability to influence decision making with respect to our business direction and policies. Parthenon Capital Partners and Invesco Ltd. may have interests different from our other stockholders' interests, and may vote in a manner adverse to those interests. Matters over which Parthenon Capital Partners and Invesco Ltd. can, directly or indirectly, exercise influence include:

- mergers and other business combination transactions, including proposed transactions that would result in our stockholders receiving a premium price for their shares;
- other acquisitions or dispositions of businesses or assets;
- incurrence of indebtedness and the issuance of equity securities;
- repurchase of stock and payment of dividends; and
- the issuance of shares to management under our equity incentive plans.

In addition, Parthenon Capital Partners has a contractual right to designate a number of directors proportionate to its stock ownership. Further, under our amended and restated certificate of incorporation, Parthenon Capital Partners does not have any obligation to present to us, and Parthenon Capital Partners may separately pursue, corporate opportunities of which it becomes aware, even if those opportunities are ones that we would have pursued if granted the opportunity.

Anti-takeover provisions contained in our certificate of incorporation and bylaws could impair a takeover attempt that our stockholders may find beneficial.

Our amended and restated certificate of incorporation and amended and restated bylaws contain provisions that could have the effect of rendering more difficult or discouraging an acquisition deemed undesirable by our board of directors. Our corporate governance documents include the following provisions: establishing a classified board of directors so that not all members of our board are elected at one time; providing that directors may be removed by stockholders only for cause; authorizing blank check preferred stock, which could be issued with voting, liquidation, dividend and other rights superior to our common stock; limiting the ability of our stockholders to call and bring business before special meetings and to take action by written consent in lieu of a meeting; limiting our ability to engage in certain business combinations with any "interested stockholder," other than Parthenon Capital Partners, for a three-year period following the time that the stockholder became an interested stockholder; requiring advance notice of stockholder proposals for business to be conducted at meetings of our stockholders and for nominations of candidates for election to our board of directors; requiring a super majority vote for certain amendments to our amended and restated certificate of incorporation and amended and restated bylaws; and limiting the determination of

the number of directors on our board of directors and the filling of vacancies or newly created seats on the board, to our board of directors then in office. These provisions, alone or together, could have the effect of delaying or deterring a change in control, could limit the opportunity for our stockholders to receive a premium for their shares of our common stock, and could also affect the price that some investors are willing to pay for our common stock.

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

Sale of Unregistered Securities

None.

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ITEM 6. EXHIBITS

(A) Exhibits:

Exhibit No. Description

- 31.1 Certification of the Chief Executive Officer pursuant to Rule 13a-14(a)/15d-14(a)
- 31.2 Certification of the Chief Financial Officer pursuant to Rule 13a-14(a)/15d-14(a)
- 32.1(1) Certification of the Chief Executive Officer pursuant to 18 USC Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
- 32.2(1) Certification of the Chief Financial Officer pursuant to 18 USC Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
- 101.INS(2) XBRL Instance Document
- 101.SCH(2)XBRL Taxonomy Extension Scheme
- 101.CAL(2)XBRL Taxonomy Extension Calculation Linkbase
- 101.DEF(2) XBRL Taxonomy Extension Definition Linkbase Document
- 101.LAB(2)XBRL Taxonomy Extension Label Linkbase
- 101.PRE(2) XBRL Taxonomy Extension Presentation Linkbase

The material contained in Exhibit 32.1 and Exhibit 32.2 is not deemed “filed” with the Securities and Exchange Commission and is not to be incorporated by reference into any filing of the Company under the Securities Act of (1) 1933 or the Securities Exchange Act of 1934, whether made before or after the date hereof and irrespective of any general incorporation language contained in such filing, except to the extent that the registrant specifically incorporates it by reference.

In accordance with Rule 406T of Regulation S-T, the information furnished in these exhibits will not be deemed (2) “filed” for purposes of Section 18 of the Exchange Act. Such exhibits will not be deemed to be incorporated by reference into any filing under the Securities Act or Exchange Act.

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SIGNATURES

Pursuant to the requirement 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.

PERFORMANT FINANCIAL CORPORATION

Date: May 6, 2016

By: /s/ Lisa Im

Lisa Im

Chief Executive Officer (Principal Executive Officer) and Director

By: /s/ Hakan Orvell

Hakan Orvell

Chief Financial Officer (Principal Financial and Accounting Officer)

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