BLACKBAUD INC
Form 10-Q
August 03, 2018
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended **June 30, 2018**

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: **000-50600**

Blackbaud, Inc.

(Exact name of registrant as specified in its charter)

Delaware	**11-2617163**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

65 Fairchild Street

Charleston, South Carolina 29492
(Address of principal executive offices, including zip code)
(843) 216-6200
(Registrant’s telephone number, including area code)
2000 Daniel Island Drive
Charleston, South Carolina 29492
(Former name, former address and former fiscal year, if changed since last report)

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

YES þ 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 (Section 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 þ NO ¨

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

Large accelerated filer	þ	Accelerated filer	¨
Non-accelerated filer	¨ (Do not check if a smaller reporting company)	Smaller reporting company	¨
		Emerging growth company	¨

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

Indicate by check mark whether registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

YES ¨ NO þ

The number of shares of the registrant’s Common Stock outstanding as ofJuly 25, 2018 was 48,584,111.

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Blackbaud, Inc.

CAUTIONARY STATEMENT REGARDING FORWARD-LOOKING STATEMENTS

This Quarterly Report on Form 10-Q, including the documents incorporated herein by reference, contains forward-looking statements that anticipate results based on our estimates, assumptions and plans that are subject to uncertainty. These "forward-looking statements" are made subject to the safe-harbor provisions of the Private Securities Litigation Reform Act of 1995, Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. Forward-looking statements consist of, among other things, trend analyses, statements regarding future events, future financial performance, our anticipated growth, the effect of general economic and market conditions, our business strategy and our plan to build and grow our business, our operating results, our ability to successfully integrate acquired businesses and technologies, the effect of foreign currency exchange rate and interest rate fluctuations on our financial results, the impact of expensing stock-based compensation, the sufficiency of our capital resources, our ability to meet our ongoing debt and obligations as they become due, and potential litigation involving us, all of which are based on current expectations, estimates, and forecasts, and the beliefs and assumptions of our management. Words such as “believes,” “seeks,” “expects,” “may,” “might,” “should,” “intends,” “could,” “would,” “likely,” “will,” “targets,” “plans,” “anticipates,” “aims,” “proje or any variations of such words and similar expressions are also intended to identify such forward-looking statements. These forward-looking statements are subject to risks, uncertainties and assumptions that are difficult to predict. Accordingly, they should not be viewed as assurances of future performance, and actual results may differ materially and adversely from those expressed in any forward-looking statements.

Important factors that could cause actual results to differ materially from our expectations expressed in forward-looking statements include, but are not limited to, those summarized under “Item 1A. Risk factors” and elsewhere in this report, in our Annual Report on Form 10-K for the year ended December 31, 2017 and in our other SEC filings. Forward-looking statements represent our management's beliefs and assumptions only as of the date of this Quarterly Report on Form 10-Q. We undertake no obligation to update or revise any forward-looking statements, or to update the reasons actual results could differ materially from those anticipated in any forward-looking statement, whether as a result of new information, future events or otherwise.

PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

Blackbaud, Inc.
Consolidated balance sheets
(Unaudited)

Assets		
Current assets:		
Cash and cash equivalents	$29,194	$29,830
Restricted cash due to customers	295,463	610,344
Accounts receivable, net of allowance of $5,501 and $5,141 at June 30, 2018 and December 31, 2017, respectively	130,509	95,679
Customer funds receivable	5,528	1,536
Prepaid expenses and other current assets	75,816	61,978
Total current assets	536,510	799,367
Property and equipment, net	44,531	42,243
Software development costs, net	62,023	54,098
Goodwill	547,312	530,249
Intangible assets, net	317,220	314,651
Other assets	64,089	57,238
Total assets	$1,571,685	$1,797,846
Liabilities and stockholders' equity		
Current liabilities:		
Trade accounts payable	$31,141	$24,693
Accrued expenses and other current liabilities	46,182	54,399
Due to customers	300,991	611,880
Debt, current portion	8,576	8,576
Deferred revenue, current portion	306,365	275,063
Total current liabilities	693,255	974,611
Debt, net of current portion	471,236	429,648
Deferred tax liability	48,055	48,023
Deferred revenue, net of current portion	3,442	3,643
Other liabilities	7,474	5,632
Total liabilities	1,223,462	1,461,557
Commitments and contingencies (see Note 10)		
Stockholders' equity:		
Preferred stock; 20,000,000 shares authorized, none outstanding	—	—
Common stock, $0.001 par value; 180,000,000 shares authorized, 59,301,209 and 58,551,761 shares issued at June 30, 2018 and December 31, 2017, respectively	59	59
Additional paid-in capital	375,949	351,042
Treasury stock, at cost; 10,735,926 and 10,475,794 shares at June 30, 2018 and December 31, 2017, respectively	(264,383)	(239,199)
Accumulated other comprehensive loss	(1,011)	(642)
Retained earnings	237,609	225,029
Total stockholders' equity	348,223	336,289
Total liabilities and stockholders' equity	$1,571,685	$1,797,846

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

Blackbaud, Inc.
Consolidated statements of comprehensive income
(Unaudited)

Revenue				
Recurring	$192,749	$166,389	$373,595	$326,436
One-time services and other	20,923	25,200	44,261	50,225
Total revenue	213,672	191,589	417,856	376,661
Cost of revenue				
Cost of recurring	76,350	66,178	145,429	130,053
Cost of one-time services and other	18,822	20,817	37,780	42,424
Total cost of revenue	95,172	86,995	183,209	172,477
Gross profit	118,500	104,594	234,647	204,184
Operating expenses				
Sales, marketing and customer success	48,493	42,580	93,970	83,577
Research and development	25,297	22,870	51,255	45,576
General and administrative	28,447	21,882	53,498	43,805
Amortization	1,201	739	2,470	1,430
Restructuring	3,688	—	4,499	—
Total operating expenses	107,126	88,071	205,692	174,388
Income from operations	11,374	16,523	28,955	29,796
Interest expense	(4,303)	(3,216)	(7,820)	(5,593)
Other income, net	346	827	506	1,113
Income before provision for income taxes	7,417	14,134	21,641	25,316
Income tax provision (benefit)	825	3,105	(2,702)	1,145
Net income	$6,592	$11,029	$24,343	$24,171
Earnings per share				
Basic	$0.14	$0.24	$0.52	$0.52
Diluted	$0.14	$0.23	$0.51	$0.51
Common shares and equivalents outstanding				
Basic weighted average shares	47,222,657	46,662,481	47,121,692	46,584,263
Diluted weighted average shares	48,053,094	47,691,340	48,030,547	47,586,893
Dividends per share	$0.12	$0.12	$0.24	$0.24
Other comprehensive (loss) income				
Foreign currency translation adjustment	(8,817)	(349)	(2,380)	(197)
Unrealized gain (loss) on derivative instruments, net of tax	765	(4)	1,844	178
Total other comprehensive loss	(8,052)	(353)	(536)	(19)
Comprehensive (loss) income	$(1,460)	$10,676	$23,807	$24,152

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

Blackbaud, Inc.
Consolidated statements of cash flows
(Unaudited)

Cash flows from operating activities		
Net income	$24,343	$24,171
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	39,847	36,481
Provision for doubtful accounts and sales returns	3,697	5,469
Stock-based compensation expense	24,953	20,129
Deferred taxes	1,121	(1,524)
Amortization of deferred financing costs and discount	376	468
Other non-cash adjustments	(419)	(540)
Changes in operating assets and liabilities, net of acquisition and disposal of businesses:		
Accounts receivable	(38,092)	(44,809)
Prepaid expenses and other assets	(18,629)	(3,262)
Trade accounts payable	6,327	(3,951)
Accrued expenses and other liabilities	(6,675)	(8,467)
Deferred revenue	29,545	30,386
Net cash provided by operating activities	66,394	54,551
Cash flows from investing activities		
Purchase of property and equipment	(9,575)	(5,666)
Capitalized software development costs	(16,359)	(13,614)
Purchase of net assets of acquired companies, net of cash and restricted cash acquired	(45,315)	(49,729)
Purchase of derivative instruments	—	(516)
Net cash used in investing activities	(71,249)	(69,525)
Cash flows from financing activities		
Proceeds from issuance of debt	173,500	575,700
Payments on debt	(132,150)	(529,169)
Debt issuance costs	—	(3,085)
Employee taxes paid for withheld shares upon equity award settlement	(25,184)	(16,644)
Proceeds from exercise of stock options	11	14
Change in due to customers	(309,189)	(85,581)
Change in customer funds receivable	(4,391)	—
Dividend payments to stockholders	(11,653)	(11,530)
Net cash used in financing activities	(309,056)	(70,295)
Effect of exchange rate on cash, cash equivalents, and restricted cash	(1,606)	(196)
Net decrease in cash, cash equivalents, and restricted cash	(315,517)	(85,465)
Cash, cash equivalents, and restricted cash, beginning of period	640,174	370,673
Cash, cash equivalents, and restricted cash, end of period	$324,657	$285,208

The following table provides a reconciliation of cash and cash equivalents and restricted cash reported within the condensed consolidated balance sheets that sum to the total of the same such amounts shown above in the consolidated statements of cash flows:

Cash and cash equivalents	$29,194	$ 29,830
Restricted cash due to customers	295,463	610,344
Total cash, cash equivalents and restricted cash in the statement of cash flows	$324,657	$ 640,174

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

Blackbaud, Inc.
Consolidated statement of stockholders' equity
(Unaudited)

Balance at December 31, 2017	58,551,761	$ 59	$ 351,042	$ (239,199)	$ (642)	$ 225,029	$ 336,289
Net income	—	—	—	—	—	24,343	24,343
Payment of dividends	—	—	—	—	—	(11,653)	(11,653)
Exercise of stock options and stock appreciation rights and vesting of restricted stock units	320,163	—	11	—	—	—	11
Employee taxes paid for 260,132 withheld shares upon equity award settlement	—	—	—	(25,184)	—	—	(25,184)
Stock-based compensation	—	—	24,896	—	—	57	24,953
Restricted stock grants	506,191	—	—	—	—	—	—
Restricted stock cancellations	(76,906)	—	—	—	—	—	—
Other comprehensive loss	—	—	—	—	(536)	—	(536)
Reclassification upon early adoption of ASU 2018-02	—	—	—	—	167	(167)	—
Balance at June 30, 2018	59,301,209	$ 59	$ 375,949	$ (264,383)	$ (1,011)	$ 237,609	$ 348,223

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

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Blackbaud, Inc.
Notes to consolidated financial statements
(Unaudited)

1. Organization

We are the world’s leading cloud software company powering social good. Serving the entire social good community—nonprofits, foundations, companies, education institutions, healthcare organizations and individual change agents—we connect and empower organizations to increase their impact through cloud software, services, expertise and data intelligence. Our portfolio is tailored to the unique needs of vertical markets, with solutions for fundraising and CRM, marketing, advocacy, peer-to-peer fundraising, corporate social responsibility, school management, ticketing, grantmaking, financial management, payment processing and analytics. Serving the industry for more than three decades, we are headquartered in Charleston, South Carolina and have operations in the United States, Australia, Canada and the United Kingdom. As of June 30, 2018, we had over 40,000 customers.

2. Basis of Presentation

Unaudited interim consolidated financial statements

The accompanying interim consolidated financial statements have been prepared pursuant to the rules and regulations of the United States Securities and Exchange Commission ("SEC") for interim financial reporting. These consolidated statements are unaudited and, in the opinion of management, include all adjustments (consisting of normal recurring adjustments and accruals) necessary to state fairly the consolidated balance sheets, consolidated statements of comprehensive income, consolidated statements of cash flows and consolidated statement of stockholders’ equity, for the periods presented in accordance with accounting principles generally accepted in the United States ("GAAP"). The consolidated balance sheet at December 31, 2017, has been derived from the audited consolidated financial statements at that date. Operating results and cash flows for the six months ended June 30, 2018 are not necessarily indicative of the results that may be expected for the fiscal year ending December 31, 2018, or any other future period. Certain information and footnote disclosures normally included in annual financial statements prepared in accordance with GAAP have been omitted in accordance with the rules and regulations for interim reporting of the SEC. These interim consolidated financial statements should be read in conjunction with the consolidated financial statements and notes thereto included in our Annual Report on Form 10-K for the year ended December 31, 2017, and other forms filed with the SEC from time to time.

Reclassifications

Our revenue from "subscriptions" and "maintenance" and a portion of our "services and other" revenue have been combined within "recurring" revenue beginning in 2018. In order to provide comparability between periods presented, those amounts of revenue have been combined within "recurring" revenue in the previously reported consolidated statements of comprehensive income to conform to presentation of the current period. Similarly, "cost of subscriptions" and "cost of maintenance" and a portion of "cost of services and other" have been combined within "cost of recurring" in the previously reported consolidated statements of comprehensive income to conform to presentation of the current period. "Services and other" revenue has been renamed as "one-time services and other" and consists of revenue that did not meet the description of "recurring" revenue in the consolidated statements of comprehensive income. "Cost of services and other" has been renamed as "cost of one-time services and other" and consists of costs that did not meet the description of those related to "recurring" revenue in the consolidated statements of comprehensive income.

Basis of consolidation

The consolidated financial statements include the accounts of Blackbaud, Inc. and its wholly-owned subsidiaries. All intercompany balances and transactions have been eliminated in consolidation.

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Blackbaud, Inc.
Notes to consolidated financial statements (continued)
(Unaudited)

Reportable segment

We report our operating results and financial information in one operating and reportable segment. Our chief operating decision maker uses consolidated financial information to make operating decisions, assess financial performance and allocate resources. Our chief operating decision maker is our chief executive officer ("CEO").

Recently adopted accounting pronouncements

In May 2014, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") 2014-09, *Revenue from Contracts with Customers (Topic 606)* ("ASU 2014-09"), which outlines a single comprehensive model for entities to use in accounting for revenue arising from contracts with customers. ASU 2014-09 replaces most previous revenue recognition guidance in GAAP and requires the recognition of revenue when promised goods or services are transferred to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. The standard also provides guidance on the recognition of costs related to obtaining and fulfilling customer contracts.

We adopted ASU 2014-09 as of January 1, 2018 utilizing the full retrospective method of transition, which requires that the standard be applied to all periods presented. The impact of adopting ASU 2014-09 on our total revenues for 2017 and 2016 was not material. The primary impacts of adopting ASU 2014-09 relate to the deferral of incremental commission and other costs of obtaining contracts with customers and the increase to the amortization period for those costs. Previously, we deferred only direct and incremental commission costs to obtain a contract and amortized those costs over the contract term, generally three years, as the revenue was recognized. Under the new standard, we defer all incremental commission and related fringe benefit costs to obtain a contract and amortize these costs in a manner that aligns with the expected period of benefit. We utilized the 'portfolio approach' practical expedient in ASC 606-10-10-4, which allows entities to apply the guidance to a portfolio of contracts with similar characteristics because the effects on the financial statements of this approach would not differ materially from applying the guidance to individual contracts. Using the 'portfolio approach' and taking into consideration our customer contracts, our technology and other factors, we determined the expected period of benefit to be five years. We do not generally pay commissions for contract renewals.

Select adjusted unaudited financial statement information, which reflects our adoption of ASU 2014-09 is set forth below.

Consolidated balance sheets:

Accounts receivable, net of allowance	$ 96,293	$ (614)	$ 95,679
Prepaid expenses and other current assets	$ 56,099	$ 5,879	$ 61,978
Other assets	$ 24,083	$ 33,155	$ 57,238
Deferred revenue, current portion	$ 276,456	$ (1,393)	$ 275,063
Deferred tax liability	$ 37,597	$ 10,426	$ 48,023
Retained earnings	$ 195,649	$ 29,380	$ 225,029

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Blackbaud, Inc.
Notes to consolidated financial statements (continued)
(Unaudited)

Consolidated statements of comprehensive income:

Revenue						
Recurring	$158,169	$ 8,220	$166,389	$310,129	$16,307	$326,436
One-time services and other	34,026	(8,826)	25,200	65,687	(15,462)	50,225
Total revenue	$192,195	$ (606)	$191,589	$375,816	$845	$376,661
Cost of Revenue						
Recurring	$63,236	$ 2,942	$66,178	$124,144	$5,909	$130,053
One-time services and other	23,759	(2,942)	20,817	48,333	(5,909)	42,424
Total cost of revenue	$86,995	$ —	$86,995	$172,477	$—	$172,477
Operating expenses						
Sales, marketing and customer success	$42,961	$ (381)	$42,580	$85,201	$(1,624)	$83,577
Net income	$11,165	$ (136)	$11,029	$22,676	$1,495	$24,171
Basic earnings per share	$0.24	$ —	$0.24	$0.49	$0.03	$0.52
Diluted earnings per share	$0.23	$ —	$0.23	$0.48	$0.03	$0.51

(1) See the discussion of our reclassifications of previously reported revenue and costs of revenue above.

Our adoption of ASU 2014-09 had no impact on our net cash provided by or used in operating, investing or financing activities for any of the periods reported.

Except for the accounting policies for revenue recognition and deferred commissions (herein referred to as "costs of obtaining contracts") that were updated as a result of adopting ASU 2014-09, there have been no changes to our significant accounting policies described in the Annual Report on Form 10-K for the year ended December 31, 2017, filed with the SEC on February 20, 2018, that have had a material impact on our consolidated financial statements.

In February 2018, the FASB issued ASU 2018-02, *Income Statement - Reporting Comprehensive Income (Topic 220): Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income* (“ASU 2018-02”), which allows a reclassification from accumulated other comprehensive income to retained earnings for stranded tax effects resulting from the U.S. Tax Cuts and Jobs Act (the “Tax Act”) signed into law in December 2017. We early adopted ASU 2018-02 effective January 1, 2018 and recorded an insignificant reclassification for the stranded tax effects resulting from the Tax Act from accumulated other comprehensive loss to retained earnings.

Summary of significant accounting policies

Revenue Recognition

Our revenue is primarily generated from the following sources: (i) charging for the use of our software solutions in cloud-based and hosted environments; (ii) providing payment and transaction services; (iii) providing software maintenance and support services; and (iv) providing professional services, including implementation, consulting, training, analytic and other services. Revenues are recognized when control of these services is transferred to our customers, in an amount that reflects the consideration we expect to be entitled to in exchange for those services.

We determine revenue recognition through the following steps:

- Identification of the contract, or contracts, with a customer;
- Identification of the performance obligations in the contract;
- Determination of the transaction price;
- Allocation of the transaction price to the performance obligations in the contract; and
- Recognition of revenue when, or as, we satisfy a performance obligation.

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Blackbaud, Inc.
Notes to consolidated financial statements (continued)
(Unaudited)

Recurring

Recurring revenue represents stand-ready performance obligations in which we are making our solutions or services available to our customers continuously over time or the value of the contract renews. Therefore, recurring revenue is generally recognized over time on a ratable basis over the contract term, beginning on the date that the solution or service is made available to the customer. Our recurring revenue contracts are generally for a term of three years at contract inception with one to three-year renewals thereafter, billed annually in advance and non-cancelable.

Recurring revenue is comprised of fees for the use of our subscription-based software solutions, which includes providing access to cloud-based solutions, hosting services, online training programs, subscription-based analytic services, such as donor acquisitions and data enrichment, and payment services. Recurring revenue also includes fees from maintenance services for our on-premises solutions, services included in our renewable subscription contracts, subscription-based contracts for professional services and variable transaction revenue associated with the use of our solutions.

Our payment services are offered with the assistance of third-party vendors. In general, when we are the principal in a transaction based on the factors identified in ASC 606-10-55-36 through 55-40, we record the revenue and related costs on a gross basis. Otherwise, we net the cost of revenue associated with the service against the gross revenue (amount billed to the customer) and record the net amount as revenue. For payment and transaction services, we have the right to invoice the customer in an amount that directly corresponds with the value to the customer of our performance to date. Therefore, we recognize revenue for these services over time based on the amount billable to the customer in accordance with the 'as invoiced' practical expedient in ASC 606-10-55-18.

One-time services and other

One-time services and other revenue primarily consists of fees for one-time consulting, analytic and onsite training services.

We generally bill consulting services based on hourly rates plus reimbursable travel-related expenses. Fixed price consulting engagements are generally billed as milestones towards completion are reached. Revenue for all consulting services is recognized over time as the services are performed.

We generally recognize analytic services revenue from donor prospect research engagements, the sale of lists of potential donors, data enrichment engagements and benchmarking studies at a point in time (upon delivery).

In certain cases, we sell training at a fixed rate for each specific class at a per attendee price or at a packaged price for several attendees, and recognize the related revenue upon the customer attending and completing training.

Contracts with multiple performance obligations

Some of our contracts with customers contain multiple performance obligations. For these contracts, we account for individual performance obligations separately if they are distinct. The transaction price is allocated to the separate performance obligations on a relative standalone selling price basis. Standalone selling prices of our solutions and services are typically estimated based on observable transactions when the solutions or services are sold on a standalone basis.

Costs of obtaining contracts, contract assets and deferred revenue

We pay sales commissions at the time contracts with customers are signed or shortly thereafter, depending on the size and duration of the sales contract. Sales commissions and related fringe benefits earned by our sales force are considered incremental and recoverable costs of obtaining a contract with a customer. These costs are deferred and then amortized in a manner that aligns with the expected period of benefit, which we have determined to be five years. We determined the period of benefit by taking into consideration our customer contracts, including renewals, retention, our technology and other factors. We do not generally pay commissions for contract renewals. The related amortization expense is included in sales, marketing and customer success expense in our consolidated statements of comprehensive income.

Amounts recognized as revenue in excess of amounts billed are recorded as contract assets within prepaid expenses and other current assets on our consolidated balance sheets. To the extent that our customers are billed for our solutions and services in advance of us satisfying the related performance obligations, we record such amounts in deferred revenue.

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Blackbaud, Inc.
Notes to consolidated financial statements (continued)
(Unaudited)

Recently issued accounting pronouncements

In February 2016, the FASB issued ASU 2016-02, *Leases (Topic 842)* ("ASU 2016-02"). ASU 2016-02 will require lessees to record most leases on their balance sheets but recognize expenses in the income statement in a manner similar to current guidance. The updated guidance also eliminates certain real estate-specific provisions and changes the guidance on sale-leaseback transactions, initial direct costs and lease executory costs for all entities. For lessors, the standard modifies the classification criteria and the accounting for sales-type and direct financing leases. All entities will classify leases to determine how to recognize lease-related revenue and expense. Classification will continue to affect amounts that lessors record on the balance sheet. ASU 2016-02 is effective for annual periods beginning after December 15, 2018, and interim periods within those years. Early adoption is permitted. Upon adoption, entities will be required to use a modified retrospective approach. The modified retrospective approach includes a number of optional practical expedients that entities may elect to apply. We expect ASU 2016-02 will impact our consolidated financial statements and related disclosures. We are currently evaluating the extent of the impact and expect that most of our lease commitments will be subject to the updated guidance and recognized as lease liabilities and right-of-use assets on our consolidated balance sheets upon adoption.

3. Business Combinations

Reeher acquisition

On April 30, 2018, we acquired all of the outstanding equity securities, including all voting equity interests, of Reeher LLC, a Minnesota limited liability company (“Reeher”), pursuant to a securities purchase agreement. The acquisition expands our fundraising performance management capabilities and is intended to drive more effective fundraising and greater social good outcomes for our customers. We acquired the equity securities for an aggregate purchase price of $41.3 million in cash, subject to certain adjustments set forth in the securities purchase agreement. The purchase price and related expenses were funded primarily through borrowings under the 2017 Credit Facility (as defined below). As a result of the acquisition, Reeher has become a wholly-owned subsidiary of ours. The operating results of Reeher have been included in our consolidated financial statements from the date of acquisition. During the three and six months ended June 30, 2018, we incurred insignificant acquisition-related expenses associated with the acquisition, which were recorded in general and administrative expense.

The fair values assigned to the assets acquired and liabilities assumed in the table below are based on our best estimates and assumptions as of the reporting date and are considered preliminary pending finalization. The estimates and assumptions are subject to change as we obtain additional information during the measurement period, which may be up to one year from the acquisition date. The assets and liabilities, pending finalization, include the valuation of intangible assets as well as the assumed deferred revenue and deferred income tax balances.

Net working capital, excluding deferred revenue	$1,683
Property and equipment	755

Identifiable intangible assets	27,055
Deferred tax asset	713
Deferred revenue	(2,700)
Goodwill	13,827
Total purchase price	$41,333

The estimated fair value of accounts receivable acquired approximates the contractual value of $1.1 million and $11.8 million of the goodwill arising in the acquisition is deductible for income tax purposes. The estimated goodwill recognized is attributable primarily to the opportunities for expected synergies from combining the operations and assembled workforce of Reeher.

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Blackbaud, Inc.
Notes to consolidated financial statements (continued)
(Unaudited)

The Reeher acquisition resulted in the identification of the following identifiable intangible assets:

Acquired technology	$ 18,900	11
Customer relationships	7,000	10
In-process research and development	600	Indefinite
Marketing assets	480	3
Non-compete agreements	75	2
Total intangible assets	$ 27,055	11

The estimated fair values of the intangible assets were based on variations of the income approach, which estimates fair value based upon the present value of cash flows that the assets are expected to generate, and which included the relief-from-royalty method, incremental cash flow method, including the comparative (with and without) method and multi-period excess earnings method, depending on the intangible asset being valued. The method of amortization of identifiable finite-lived intangible assets is based on the expected pattern in which the estimated economic benefits of the respective assets are consumed or otherwise used up. Customer relationships and acquired technology are being amortized on an accelerated basis. Marketing assets and non-compete agreements are being amortized on a straight-line basis.

We determined that the impact of this acquisition was not material to our consolidated financial statements; therefore, revenue and earnings since the acquisition date and pro forma information are not required or presented.

4. Goodwill

The change in goodwill during the six months ended June 30, 2018, consisted of the following:

Balance at December 31, 2017	$ 530,249
Additions related to current year business combinations	18,417
Adjustments related to prior year business combinations	(141)
Effect of foreign currency translation	(1,213)
Balance at June 30, 2018	$ 547,312

5. Earnings Per Share

We compute basic earnings per share by dividing net income available to common stockholders by the weighted average number of common shares outstanding during the period. Diluted earnings per share is computed by dividing net income available to common stockholders by the weighted average number of common shares and dilutive potential common shares outstanding during the period. Diluted earnings per share reflect the assumed exercise, settlement and vesting of all dilutive securities using the “treasury stock method” except when the effect is anti-dilutive. Potentially dilutive securities consist of shares issuable upon the exercise of stock options, settlement of stock appreciation rights and vesting of restricted stock awards and units.

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Blackbaud, Inc.
Notes to consolidated financial statements (continued)
(Unaudited)

The following table sets forth the computation of basic and diluted earnings per share:

	Three months ended June 30,		Six months ended June 30,	
Numerator:				
Net income	$ 6,592	$ 11,029	$ 24,343	$ 24,171
Denominator:				
Weighted average common shares	47,222,657	46,662,481	47,121,692	46,584,263
Add effect of dilutive securities:				
Stock-based awards	830,437	1,028,859	908,855	1,002,630
Weighted average common shares assuming dilution	48,053,094	47,691,340	48,030,547	47,586,893
Earnings per share:				
Basic	$ 0.14	$ 0.24	$ 0.52	$ 0.52
Diluted	$ 0.14	$ 0.23	$ 0.51	$ 0.51
Anti-dilutive shares excluded from calculations of diluted earnings per share	—	—	37	5,515

6. Fair Value Measurements

We use a three-tier fair value hierarchy to measure fair value. This hierarchy prioritizes the inputs into three broad levels as follows:

- Level 1 - Quoted prices for identical assets or liabilities in active markets;
- Level 2 - Quoted prices for similar assets and liabilities in active markets, quoted prices for identical or similar assets in markets that are not active, and model-derived valuations in which all significant inputs and significant value drivers are observable in active markets; and
- Level 3 - Valuations derived from valuation techniques in which one or more significant inputs are unobservable.

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Blackbaud, Inc.
Notes to consolidated financial statements (continued)
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Recurring fair value measurements

Financial assets and liabilities measured at fair value on a recurring basis consisted of the following, as of the dates indicated below:

Fair value as of June 30, 2018				
Financial assets:				
Derivative instruments	$—	$3,789	$ —	$3,789
Total financial assets	$—	$3,789	$ —	$3,789
Fair value as of December 31, 2017				
Financial assets:				
Derivative instruments	$—	$1,283	$ —	$1,283
Total financial assets	$—	$1,283	$ —	$1,283

Our derivative instruments within the scope of ASC 815, *Derivatives and Hedging*, are required to be recorded at fair value. Our derivative instruments that are recorded at fair value include interest rate swaps.

The fair value of our interest rate swaps was based on model-driven valuations using LIBOR rates, which are observable at commonly quoted intervals. Accordingly, our interest rate swaps are classified within Level 2 of the fair value hierarchy.

We believe the carrying amounts of our cash and cash equivalents, restricted cash due to customers, accounts receivable, trade accounts payable, accrued expenses and other current liabilities and due to customers approximate their fair values at June 30, 2018 and December 31, 2017, due to the immediate or short-term maturity of these instruments.

We believe the carrying amount of our debt approximates its fair value at June 30, 2018 and December 31, 2017, as the debt bears interest rates that approximate market value. As LIBOR rates are observable at commonly quoted intervals, our debt is classified within Level 2 of the fair value hierarchy.

We did not transfer any assets or liabilities among the levels within the fair value hierarchy during the six months ended June 30, 2018. Additionally, we did not hold any Level 3 assets or liabilities during the six months ended June 30, 2018.

Non-recurring fair value measurements

Assets and liabilities that are measured at fair value on a non-recurring basis include intangible assets and goodwill, which are recognized at fair value during the period in which an acquisition is completed, from updated estimates and assumptions during the measurement period, or when they are considered to be impaired. These non-recurring fair value measurements, primarily for intangible assets acquired, are based on Level 3 unobservable inputs. In the event of an impairment, we determine the fair value of the goodwill and intangible assets using a discounted cash flow approach, which contains significant unobservable inputs and, therefore, is considered a Level 3 fair value measurement. The unobservable inputs in the analysis generally include future cash flow projections and a discount rate.

There were no non-recurring fair value adjustments to intangible assets and goodwill during the six months ended June 30, 2018, except for an insignificant business combination accounting adjustment to the initial fair value estimates of the assets acquired and liabilities assumed at the acquisition date from updated information obtained during the measurement period. See Note 4 to these consolidated financial statements for additional details. The measurement period of a business combination may be up to one year from the acquisition date. We record any measurement period adjustments to the fair value of assets acquired and liabilities assumed, with the corresponding offset to goodwill.

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Blackbaud, Inc.
Notes to consolidated financial statements (continued)
(Unaudited)

7. Consolidated Financial Statement Details

Prepaid expenses and other assets

Costs of obtaining contracts[1]	$81,631	$ 77,312
Prepaid software maintenance and subscriptions	23,856	17,402
Taxes, prepaid and receivable	14,531	10,548
Derivative instruments	3,789	1,283
Contract assets	3,933	3,136
Security deposits	2,741	2,305
Other assets	9,424	7,230
Total prepaid expenses and other assets	139,905	119,216
Less: Long-term portion	64,089	57,238
Prepaid expenses and other current assets	$75,816	$ 61,978

(1) Amortization expense from costs of obtaining contracts was $17.6 million for the six months ended June 30, 2018.

Accrued expenses and other liabilities

Accrued bonuses	$11,134	$ 16,743
Accrued commissions and salaries	8,917	6,943
Lease incentive obligations	4,186	4,635
Customer credit balances	3,413	4,652
Deferred rent liabilities	4,678	4,548
Taxes payable	3,270	5,517
Unrecognized tax benefit	3,112	1,972
Accrued vacation costs	2,366	2,458
Accrued health care costs	2,885	2,615
Other liabilities	9,695	9,948
Total accrued expenses and other liabilities	53,656	60,031
Less: Long-term portion	7,474	5,632
Accrued expenses and other current liabilities	$46,182	$ 54,399

Other income, net

	Three months ended June 30,		Six months ended June 30,	
Interest income	$277	$210	$669	$378
Gain on derivative instrument	—	475	—	475
Loss on debt extinguishment	—	(162)	—	(162)
Other income (expense), net	69	304	(163)	422
Other income, net	$346	$827	$506	$1,113

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Blackbaud, Inc.
Notes to consolidated financial statements (continued)
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8. Debt

The following table summarizes our debt balances and the related weighted average effective interest rates, which includes the effect of interest rate swap agreements.

Credit facility:				
Revolving credit loans	$188,100	$143,000	3.58 %	2.84 %
Term loans	292,500	296,250	3.30 %	2.64 %
Other debt	1,076	1,076	4.50 %	4.50 %
Total debt	481,676	440,326	3.41 %	2.71 %
Less: Unamortized discount and debt issuance costs	1,864	2,102		
Less: Debt, current portion	8,576	8,576	3.49 %	3.03 %
Debt, net of current portion	$471,236	$429,648	3.41 %	2.71 %

In June 2017, we entered into a five-year $700.0 million senior credit facility (the "2017 Credit Facility"). As of June 30, 2018, the required annual maturities related to the 2017 Credit Facility and other debt were as follows:

2018 - remaining	$4,826
2019	7,500
2020	7,500
2021	7,500
2022	454,350
Thereafter	—
Total required maturities	$481,676

9. Derivative Instruments

Cash flow hedges

We generally use derivative instruments to manage our variable interest rate risk. In July 2017, we entered into an interest rate swap agreement (the "July 2017 Swap Agreement"), which effectively converts portions of our variable rate debt under our credit facility to a fixed rate for the term of the July 2017 Swap Agreement. The notional value of the July 2017 Swap Agreement was $150.0 million with an effective date beginning in July 2017 through July 2021. We designated the July 2017 Swap Agreement as a cash flow hedge at the inception of the contract.

In February 2018, we entered into an additional interest rate swap agreement (the "February 2018 Swap Agreement"), which effectively converts portions of our variable rate debt under our credit facility to a fixed rate for the term of the February 2018 Swap Agreement. The notional value of the February 2018 Swap Agreement was $50.0 million with an effective date beginning in February 2018 through June 2021. We designated the February 2018 Swap

Agreement as a cash flow hedge at the inception of the contract.

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Blackbaud, Inc.
Notes to consolidated financial statements (continued)
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Undesignated contracts

In June 2017, we entered into a foreign currency option contract to hedge our exposure to currency fluctuations in connection with our acquisition of JustGiving because the purchase price was denominated in British Pounds. The notional value of the instrument was £100.0 million with an effective date beginning in June 2017 and maturing in September 2017. We settled the foreign currency option contract in September 2017. We did not designate the foreign currency option contract as a cash flow hedge for accounting purposes since it involved a business combination. As such, changes in the fair value of this derivative were recognized in earnings. The insignificant premium paid for this option is shown within cash flows from investing activities in our consolidated statements of cash flows.

The fair values of our derivative instruments were as follows as of:

Derivative instruments designated as hedging instruments:						
Interest rate swaps, current portion	Prepaid expenses and other current assets	$—	$ 145	Accrued expenses and other current liabilities	$ —	$ —
Interest rate swaps, long-term portion	Other assets	3,789	1,138	Other liabilities	—	—
Total derivative instruments designated as hedging instruments		$3,789	$ 1,283		$ —	$ —

The effects of derivative instruments in cash flow hedging relationships were as follows: