ELLIE MAE INC
Form 10-Q
August 07, 2013
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended June 30, 2013

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: 001-35140

ELLIE MAE, INC.
(Exact name of registrant as specified in its charter)

Delaware (State or other jurisdiction of incorporation or organization)	94-3288780 (I.R.S. Employer Identification No.)
4155 Hopyard Road, Suite 200 Pleasanton, California (Address of principal executive offices)	94588 (Zip Code)

(925) 227-7000
(Registrant's telephone number, including area code)

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

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

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

Large accelerated filer¨		Accelerated filer	x
Non-accelerated filer o (Do not check if smaller reporting company)		Smaller reporting company	¨

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

Indicate the number of shares outstanding of each of the registrant’s classes of common stock as of the latest practicable date:

As of July 31, 2013:

Class	Number of Shares
Common Stock, $0.0001 par value	26,467,390

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PART I—FINANCIAL INFORMATION
ITEM 1—CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
Ellie Mae, Inc.
CONDENSED CONSOLIDATED BALANCE SHEETS
(UNAUDITED)
(in thousands, except share and per share amounts)

	June 30, 2013	December 31, 2012
Assets		
Current assets		
Cash and cash equivalents	$41,726	$44,114
Short-term investments	29,253	16,243
Accounts receivable, net of allowances for doubtful accounts of $57 and $74 as of June 30, 2013 and December 31, 2012, respectively	11,460	9,753
Prepaid expenses and other current assets	3,930	2,956
Deferred tax assets	652	645
Note receivable	1,000	1,000
Total current assets	88,021	74,711
Property and equipment, net	11,880	9,494
Long-term investments	51,245	43,728
Other intangible assets, net	5,810	6,531
Goodwill	51,051	51,051
Deposits and other assets	1,398	100
Total assets	$209,405	$185,615
Liabilities and Stockholders' Equity		
Current liabilities		
Accounts payable	$3,737	$2,039
Accrued and other current liabilities	8,365	5,777
Income taxes payable	2,030	15
Acquisition holdback, net of discount	2,990	2,948
Deferred revenue	4,625	4,896
Deferred rent	271	252
Total current liabilities	22,018	15,927
Acquisition holdback, net of current portion and discount	1,938	1,911
Other long-term liabilities	1,357	915
Total liabilities	25,313	18,753
Commitments and contingencies (Note 7)		
Stockholders' equity:		
Common stock, $0.0001 par value per share; 140,000,000 authorized shares, 26,437,235 and 26,058,533 shares issued and outstanding as of June 30, 2013 and December 31, 2012, respectively	3	3
Additional paid-in capital	194,371	184,616
Accumulated other comprehensive loss	(188)	(65)
Accumulated deficit	(10,094)	(17,692)
Total stockholders' equity	184,092	166,862
Total liabilities and stockholders' equity	$209,405	$185,615

See accompanying notes to these condensed consolidated financial statements (unaudited).

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Ellie Mae, Inc.
CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(UNAUDITED)
(in thousands, except share and per share amounts)

	Three months ended June 30,		Six months ended June 30,	
	2013	2012	2013	2012
Revenues	$34,270	$23,569	$65,125	$44,475
Cost of revenues	8,607	5,283	16,218	10,540
Gross profit	25,663	18,286	48,907	33,935
Operating expenses:				
Sales and marketing	5,167	4,232	10,070	8,232
Research and development	6,530	4,299	12,078	8,432
General and administrative	7,975	4,496	15,561	8,172
Total operating expenses	19,672	13,027	37,709	24,836
Income from operations	5,991	5,259	11,198	9,099
Other income (expense), net	151	(18)	272	(38)
Income before income taxes	6,142	5,241	11,470	9,061
Income tax provision	2,457	242	3,872	420
Net income	$3,685	$4,999	$7,598	$8,641
Net income per share of common stock:				
Basic	$0.14	$0.23	$0.29	$0.40
Diluted	$0.13	$0.21	$0.27	$0.38
Weighted average common shares used in computing net income per share of common stock:				
Basic	26,368,860	21,610,578	26,268,134	21,507,683
Diluted	28,281,922	23,296,653	28,182,572	22,939,744
Net income	$3,685	$4,999	$7,598	$8,641
Other comprehensive loss, net of taxes				
Unrealized losses on investments	(28)	—	(123)	—
Comprehensive income	$3,657	$4,999	$7,475	$8,641

See accompanying notes to these condensed consolidated financial statements (unaudited).

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Ellie Mae, Inc.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(UNAUDITED)
(in thousands)

	Six months ended June 30, 2013	Six months ended June 30, 2012
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	$7,598	$8,641
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	2,273	1,362
Provision for uncollectible accounts receivable	1	8
Amortization of other intangible assets	721	818
Amortization of discount related to acquisition holdback	69	109
Stock-based compensation	7,508	1,395
Loss on sale of property and equipment	—	20
Excess tax benefit from exercise of stock options	(249)	(181)
Deferred income taxes	(137)	—
Amortization of investment premium	852	—
Changes in operating assets and liabilities:		
Accounts receivable	(1,708)	(1,100)
Prepaid expenses and other current assets	(549)	(1,232)
Deposits and other assets	(1,116)	—
Accounts payable	1,640	(802)
Income taxes payable	2,015	—
Accrued and other current liabilities	2,119	1,690
Deferred revenue	(252)	(412)
Deferred rent	(123)	(103)
Net cash provided by operating activities	20,662	10,213
CASH FLOWS FROM INVESTING ACTIVITIES:		
Acquisition of property and equipment	(3,393)	(3,845)
Proceeds from sale of property and equipment	—	10
Purchase of investments	(63,344)	(3,473)
Maturities of investments	41,842	2,486
Other investing activities, net	—	2
Net cash used in investing activities	(24,895)	(4,820)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Payment of capital lease obligations	(363)	(3)
Proceeds from issuance of common stock under stock incentive plans	1,985	1,621
Cash paid for net settlement of vested restricted stock units	(26)	—
Excess tax benefit from exercise of stock options	249	181
Net cash provided by financing activities	1,845	1,799
NET (DECREASE) INCREASE IN CASH AND CASH EQUIVALENTS	(2,388)	7,192
CASH AND CASH EQUIVALENTS, Beginning of period	44,114	23,732
CASH AND CASH EQUIVALENTS, End of period	$41,726	$30,924
Supplemental disclosure of cash flow information:		
Cash paid for interest	$156	$—
Cash paid for income taxes	$1,736	$120

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Supplemental disclosure of non-cash investing and financing activities:		
Fixed asset purchases not yet paid	$218	$673
Fixed assets acquired under capital lease	$1,336	$—
Deferred offering costs not yet paid	$—	$344

See accompanying notes to these condensed consolidated financial statements (unaudited).

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Ellie Mae, Inc.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(UNAUDITED)

NOTE 1—Description of Business

Ellie Mae, Inc. (“Ellie Mae,” “the Company,” “we,” “our” or “us”) is a leading provider of on-demand automation solutions for the residential mortgage industry in the United States. Our on-demand, technology-enabled software solutions help streamline and automate the process of originating and funding new mortgage loans, thereby increasing efficiency, facilitating regulatory compliance and reducing documentation errors.

NOTE 2—Basis of Presentation and Significant Accounting Policies

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with generally accepted accounting principles in the United States (“GAAP”) and applicable rules and regulations of the Securities and Exchange Commission (“SEC”) regarding interim financial reporting. Certain information and note disclosures normally included in financial statements prepared in accordance with GAAP have been condensed or omitted pursuant to such rules and regulations. Therefore, these condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and notes included in our Annual Report on Form 10-K for the year ended December 31, 2012, which was filed with the SEC on March 1, 2013 (“2012 Form 10-K”). The condensed consolidated balance sheet as of December 31, 2012, included herein, was derived from the audited financial statements as of that date but does not include all disclosures, including notes required by GAAP.

In the opinion of management, the accompanying unaudited condensed consolidated financial statements reflect all normal recurring adjustments necessary to present fairly the financial positions, results of operations and cash flows for the interim periods, but are not necessarily indicative of the results of operations to be anticipated for the full year 2013 or any future period.

Principles of Consolidation

The condensed consolidated financial statements include the accounts of Ellie Mae and our wholly-owned subsidiaries. All intercompany balances and transactions have been eliminated.

Use of Estimates

The preparation of condensed consolidated financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reporting period. Actual results could differ from those estimates.

Significant Accounting Policies

Our significant accounting policies are described in Note 2 of the Notes to Consolidated Financial Statements in our 2012 Form 10-K. There have been no significant changes to these policies except as noted below.

Deferred Commission Expense

Deferred commission expenses are the incremental costs that are directly associated with non-cancelable subscription contracts with customers and consist of sales commissions paid to our direct sales force. Commissions are calculated based on a percentage of the revenue for the non-cancelable term of subscription contracts, which are typically one to five years.

Prior to 2013, commissions were paid and recognized as sales expense when customer payments for contracted services were received on a monthly basis because commissions were earned based on receipt of customer payments. In 2013, we amended our commission plans to provide for payment after the customer's contract is signed. As a result of the change in commission plans, beginning in 2013, commission expense is deferred and amortized to sales expense over the non-cancelable terms of the related subscription contracts. The deferred commission expense amounts are recoverable through the future revenue streams under the non-cancelable customer contracts. The new plans also include claw back provisions, which allow for repayment of a proportionate amount of commissions, should customers cancel their contracts prior to the end of the initial contractual term.

During six months ended June 30, 2013, we deferred $928 thousand of commission expense, of which $860 thousand remained on our condensed consolidated balance sheets at June 30, 2013. No amounts were deferred as of December 31, 2012.

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Comprehensive Income

Comprehensive income consists of net income and other comprehensive loss. Other comprehensive loss includes certain changes in equity that are excluded from net income, specifically unrealized gains and losses on available-for-sale investments. There were no reclassifications out of accumulated other comprehensive income (“AOCI”) that affected net income during the three and six months ended June 30, 2013 and 2012.

Recent Accounting Pronouncements

In February 2013, the Financial Accounting Standards Board ("FASB") issued an amendment to Accounting Standards Codification Topic 220, Comprehensive Income, in Accounting Standards Update (“ASU”) 2013-02. Under ASU 2013-02, an entity must make new disclosures for changes in AOCI balances by component as well as significant items reclassified out of AOCI. We adopted ASU 2013-02 on January 1, 2013 and this adoption did not have a material impact on our consolidated financial statements.

In July 2013, the FASB issued ASU No. 2013-11, Topic 740 - Income Taxes ("ASU 2013-11") which provides guidance to improve the presentation of an unrecognized benefit when a net operating loss carryforward, a similar tax loss, or a tax credit carryforward exists. ASU 2013-11 is effective for fiscal year, and interim periods within those years, beginning after December 15, 2013. We intend to adopt this standard in the first fiscal quarter of the year ending December 31, 2014 and do not expect the adoption will have a significant impact on its consolidated financials.

NOTE 3—Net Income Per Share of Common Stock

Net income per share of common stock is calculated by dividing net income by the weighted average shares of common stock outstanding during the period. Diluted net income per share of common stock is calculated by dividing net income by the weighted average shares of common stock outstanding and potential shares of common stock during the period. Potential shares of common stock include dilutive shares attributable to the assumed exercise of stock options, restricted stock unit awards (“RSUs”), performance share awards (“Performance Awards”) and Employee Stock Purchase Plan (“ESPP”) shares using the treasury stock method, if dilutive.

The components of net income per share of common stock were as follows:

	Three months ended June 30,		Six months ended June 30,	
	2013	2012	2013	2012
	(in thousands, except share and per share amounts)			
Net income	$3,685	$4,999	$7,598	$8,641
Basic shares:				
Weighted average common shares outstanding	26,368,860	21,610,578	26,268,134	21,507,683
Diluted shares:				
Weighted average shares used to compute basic net income per share	26,368,860	21,610,578	26,268,134	21,507,683
Effect of potentially dilutive securities:				
Employee stock options, restricted stock units, Performance Awards and ESPP shares	1,913,062	1,686,075	1,914,438	1,432,061
Weighted average shares used to compute diluted net income per share	28,281,922	23,296,653	28,182,572	22,939,744
Net income per share:				
Basic	$0.14	$0.23	$0.29	$0.40
Diluted	$0.13	$0.21	$0.27	$0.38

The following potential common shares were excluded from the computation of diluted net income per share, as their effect would have been anti-dilutive:

	Three months ended June 30,		Six months ended June 30,	
	2013	2012	2013	2012
Employee stock options and awards	876,237	144,700	613,679	641,002

Performance-based awards are included in the diluted shares outstanding for each period if the established performance criteria have been met at the end of the respective periods. However, if none of the required performance criteria have been met

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for such awards, we include the number of shares that would be issuable if the end of the reporting period were the end of the contingency period. Accordingly, in addition to the employee stock options and awards noted above, 192,100 and 583,333 shares underlying Performance Awards have been excluded from the dilutive shares outstanding for each of the three and six months ended June 30, 2013 and 2012, respectively.

NOTE 4—Financial Instruments and Fair Value Measurements

Fair value is defined as the price that would be received from selling an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Fair value measurements are classified and disclosed in one of the following three categories:

Level 1— Valuations based on quoted prices in active markets for identical assets or liabilities.

Level 2— Valuations based on other than quoted prices in active markets for identical assets and liabilities, quoted prices for identical or similar assets or liabilities in inactive markets, or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities.

Level 3— Valuations based on inputs that are generally unobservable and typically reflect management's estimates of assumptions that market participants would use in pricing the assets or liabilities.

The following tables set forth by level within the fair value hierarchy our financial assets that were accounted for at fair value on a recurring basis, according to the valuation techniques we used to determine their values:

	Fair value at	Fair value measurements using inputs considered as		
	June 30, 2013 (in thousands)	Level 1	Level 2	Level 3
Money market funds	$21,812	$21,812	$—	$—
Certificates of deposit	13,183	—	13,183	—
Corporate notes and obligations	31,319	—	31,319	—
Municipal obligations	3,324	—	3,324	—
U.S. government and government agency obligations	34,672	11,175	23,497	—
	$104,310	$32,987	$71,323	$—

	Fair value at	Fair value measurements using inputs considered as		
	December 31, 2012 (in thousands)	Level 1	Level 2	Level 3
Money market funds	$36,453	$36,453	$—	$—
Corporate notes and obligations	39,148	—	39,148	—
Municipal obligations	6,230	—	6,230	—
U.S. government and government agency obligations	15,048	4,711	10,337	—
	$96,879	$41,164	$55,715	$—

Financial instruments include cash, cash equivalents and investments including investment-grade interest-bearing securities such as money market accounts, certificates of deposit, commercial paper, corporate bonds, municipal and government agency obligations and guaranteed obligations of the U.S. government. We classify our money market funds and U.S. government obligations as Level 1 instruments due to the use of observable market prices for identical securities that are traded in active markets.

When we use observable market prices for identical securities that are traded in less active markets, we classify our marketable financial instruments as Level 2. When observable market prices for identical securities are not available, we price our marketable financial instruments using non-binding market consensus prices that are corroborated with observable market data; quoted market prices for similar instruments; or pricing models with all significant inputs derived from or corroborated with observable market data. Non-binding market consensus prices are based on the proprietary valuation models of pricing providers. These valuation models incorporate a number of inputs, including non-binding and binding broker quotes; observable market prices for identical or similar securities; and the internal assumptions of pricing providers or brokers that use observable market inputs and, to a lesser degree, unobservable market inputs. We corroborate non-binding market consensus prices with observable market data as such data exists.

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As of June 30, 2013 and December 31, 2012, we did not have any assets or liabilities that were valued using Level 3 inputs. For the three and six months ended June 30, 2013 and 2012, there were no transfers of financial instruments among Level 1, Level 2 or Level 3 classifications.

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The carrying amounts and estimated fair value of cash and cash equivalents and both short and long-term investments consisted of the following:

	June 30, 2013		
	Amortized cost	Unrealized gains (losses)	Carrying or fair value
	(in thousands)		
Cash and cash equivalents:			
Cash	$17,914	$—	$17,914
Money market funds	21,812	—	21,812
U.S. government notes	2,000	—	2,000
	$41,726	$—	$41,726
Short-term investments:			
Certificates of deposit	$2,695	$(6)	$2,689
Corporate notes and obligations	14,389	(10)	14,379
Municipal obligations	1,719	1	1,720
U.S. government notes	2,020	2	2,022
U.S. government agency securities	8,441	2	8,443
	$29,264	$(11)	$29,253
Long-term investments:			
Certificates of deposit	$10,535	$(41)	$10,494
Corporate notes and obligations	17,001	(61)	16,940
Municipal obligations	1,610	(7)	1,603
U.S. government notes	7,172	(20)	7,152
U.S. government agency securities	15,104	(48)	15,056
	$51,422	$(177)	$51,245

	December 31, 2012		
	Amortized cost	Unrealized gains (losses)	Carrying or fair value
	(in thousands)		
Cash and cash equivalents:			
Cash	$7,206	$—	$7,206
Money market funds	36,453	—	36,453
Corporate notes and obligations	455	—	455
	$44,114	$—	$44,114
Short-term investments:			
Corporate notes and obligations	$10,292	$(5)	$10,287
Municipal obligations	2,829	(6)	2,823
U.S. government agency securities	3,132	1	3,133
	$16,253	$(10)	$16,243
Long-term investments:			
Corporate notes and obligations	$28,462	$(56)	$28,406
Municipal obligations	3,412	(5)	3,407
U.S. government notes	4,710	1	4,711
U.S. government agency securities	7,199	5	7,204
	$43,783	$(55)	$43,728

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The following table summarizes the maturities of our investments at June 30, 2013:

	Carrying or fair value (in thousands)
Remainder of 2013	$7,041
2014	32,579
2015	32,467
2016	8,411
Total	$80,498

Actual maturities may differ from the contractual maturities because borrowers may have the right to call or prepay certain obligations.

NOTE 5— Goodwill and Other Intangible Assets

There were no changes in the carrying value of goodwill during the three and six months ended June 30, 2013.

Other intangible assets, net, consisted of the following:

	June 30, 2013			
	Gross carrying amount	Accumulated amortization	Net intangibles	Weighted Average Remaining Useful Life
	(in thousands)			(in years)
Developed technology	$1,874	$(1,335)	$539	1.7
Trade names	260	(158)	102	1.5
Customer lists and contracts	7,300	(2,131)	5,169	5.6
	$9,434	$(3,624)	$5,810	5.1

	December 31, 2012			
	Gross carrying amount	Accumulated amortization	Net intangibles	Weighted Average Remaining Useful Life
	(in thousands)			(in years)
Developed technology	$1,874	$(1,170)	$704	2.2
Trade names	260	(124)	136	2.0
Customer lists and contracts	7,300	(1,609)	5,691	6.0
	$9,434	$(2,903)	$6,531	5.5

Amortization expense associated with other intangible assets was $0.4 million and $0.7 million for the three and six months ended June 30, 2013, respectively, and $0.4 million and $0.8 million for the three and six months ended June 30, 2012. There was no impairment of intangible assets during the three and six months ended June 30, 2013 and 2012.

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Minimum future amortization expense for other intangible assets at June 30, 2013 was as follows:

	Amortization (in thousands)
Remainder of fiscal 2013	$721
2014	1,405
2015	1,033
2016	928
2017	928
2018	266
Thereafter	529
	$5,810

NOTE 6—Income Taxes

We compute our interim provision for income taxes by applying the estimated annual effective tax rate to the year-to-date income from recurring operations and adjust the provision for discrete tax items recorded in the period. We evaluate our effective income tax rate on a quarterly basis and update our estimated annual effective income tax rate as necessary. The estimated annual effective tax rate for the six months ended June 30, 2013 and 2012 was 40.0% and 4.6%, respectively.

The difference between the federal statutory rate of 35% and our estimated annual effective tax rate for the six months ended June 30, 2013 was primarily due to our blended state income tax rate and the Section 162(m) limitation on the tax deduction for the annual compensation paid to our chief executive officer and the three other most highly paid executive officers, not including the chief financial officer (collectively the "Covered Employees"). The tax provision for six months ended June 30, 2013 includes a discrete benefit item of $0.5 million related to 2012 federal research and development tax credit that were retroactively reinstated by Congress in 2013.

Our tax positions are subject to income tax audits by multiple tax jurisdictions. We account for uncertain tax provisions and we have a policy to classify accrued interest and penalties associated with uncertain tax positions together with the related liability, and the expenses incurred related to such accruals are included in the provision for income taxes. We believe that we have provided adequate reserves for our unrecognized tax benefits and associated penalties and interest, if applicable, for all tax years still open for assessment.

NOTE 7—Commitments and Contingencies

Leases

In January 2013, we entered into an agreement to lease additional office space at our corporate headquarters. The lease expires in April 2015 with payments of $20,000 per month over the term of the lease agreement. In April 2013, we entered into an agreement to finance the purchase of computer equipment with payments of $59,000 per month over the 23 month term of the agreement.

Legal Proceedings

On March 25, 2011, Industry Access Incorporated (“Industry Access”) filed a patent infringement lawsuit against us and another defendant in the U.S. District Court for the Central District of California. The complaint alleges, among other things, that certain aspects of our Encompass360 loan management software system and related operations infringe a single patent, and seeks declaratory relief and unspecified damages from the defendants, including enhanced damages for willful infringement and reasonable attorneys’ fees. On June, 24, 2011, the Court issued an order requiring plaintiff to serve the complaint on all defendants within three days of the order. On June 28, 2011, plaintiff served us with the complaint and we filed its answer on August 5, 2011 denying all material allegations of the complaint. On November 18, 2011 the other defendant filed with the United States Patent and Trademark Office (the “PTO”) a request for ex parte reexamination of Industry Access’ US Patent No 7,769,681, which the PTO granted on February 14, 2012. On December 15, 2011, we filed a motion to stay the litigation pending the reexamination, which the Court granted on February 28, 2012. On October 9, 2012, the PTO issued the reexamination certificate. The Court granted a motion to dismiss the other defendant from this action on April 7, 2013 and lifted the stay on April 11, 2013. The parties are in the claims construction phase of the litigation with a claim construction hearing to be scheduled. The trial is scheduled for August 2014.

On March 19, 2013, Industry Access filed a second patent infringement lawsuit against us in the U.S. District Court for the Central District of California. The complaint alleges, among other things, that our Encompass360 loan management software

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system, including the Encompass software, the Ellie Mae Network, Encompass Originator, Encompass Compliance Service, Encompass CenterWise, Encompass Electronic Document Management, Encompass Docs Solution and Encompass Product and Pricing Service, infringes U.S. Patent Nos. 8,117,120 and 8,145,563, which are continuations of U.S. Patent No. 7,769,681, asserted in the lawsuit described above. Plaintiff is seeking unspecified damages. On June 12, 2013, we filed a motion to dismiss or, in the alternative, to transfer this case to the Northern District of California. A hearing on these motions and a case management conference are both scheduled for September 16, 2013.

We believe that we have substantial and meritorious defenses in each of these cases and, if similar claims are pursued, we intend to defend these and similar claims vigorously.

We are also subject to various other legal proceedings and claims arising in the ordinary course of business. With respect to these matters and the litigations described above, we cannot predict the ultimate outcome of these legal proceedings and the amounts and ranges of potential damages associated with such proceedings cannot be estimated or assessed. An unfavorable outcome of these or the litigation could materially adversely affect our business, financial condition and results of operations.

NOTE 8—Stock Incentive Plans

We recognize stock-based compensation related to awards granted under our 2009 Stock Option and Incentive Plan (the “2009 Plan”), 2011 Equity Incentive Award Plan (the “2011 Plan”) and ESPP.

Total stock-based compensation expense recognized consisted of:

	Three months ended June 30,		Six months ended June 30,	
	2013	2012	2013	2012
	(in thousands)			
Cost of revenues	$171	$59	$270	$90
Sales and marketing	250	100	387	170
Research and development	943	252	1,628	384
General and administrative	2,771	467	5,223	751
	$4,135	$878	$7,508	$1,395

Capitalized stock-based compensation for the three and six months ended June 30, 2013 and 2012 was not significant.

2009 Stock Option and Incentive Plan and 2011 Equity Incentive Award Plan

Stock Options

The following table summarizes our stock option activity under the 2009 Plan and 2011 Plan:

	Number of Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term (in years)	Aggregate Intrinsic Value (in thousands)
Outstanding at January 1, 2013	3,461,255	$7.19		
Granted	717,952	$22.87		
Exercised	(318,898)	$3.27		
Forfeited or expired	(73,780)	$17.24		
Outstanding at June 30, 2013	3,786,529	$10.30	7.46	$49,163
Ending vested and expected to vest at June 30, 2013	3,692,151	$10.10	7.41	$48,631
Exercisable at June 30, 2013	1,890,826	$5.65	6.03	$32,957

There were no grants under the 2009 plan during the six months ended June 30, 2013 and 2012.

Intrinsic value of an option is the difference between the fair value of our common stock at the time of exercise and the exercise price to be paid. The aggregate intrinsic value for options outstanding at June 30, 2013 in the table above represents the total intrinsic value, based on our closing stock price of $23.08 as of June 30, 2013, which would have been received by option holders had all option holders exercised their in-the-money options as of that date. Options outstanding that are expected to vest are net of estimated future option forfeitures.

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Following is additional information pertaining to our stock option activity:

	Three months ended June 30,		Six months ended June 30,	
	2013	2012	2013	2012
	(in thousands, except per option amounts)			
Weighted average fair value per option granted	$11.62	$7.97	$11.23	$5.82
Grant-date fair value of options vested	$945	$423	$1,972	$696
Intrinsic value of options exercised	$3,035	$450	$6,393	$2,558
Proceeds received from options exercised	$616	$115	$1,043	$1,274

As of June 30, 2013, total unrecognized stock-based compensation expense related to unvested stock options, adjusted for estimated forfeitures, was $12.8 million and is expected to be recognized over a weighted average period of 2.7 years.

Restricted Stock Units and Performance Awards

On August 2012, the Company granted 147,000 Performance Awards to designated participants under the 2011 Plan. A Performance Award represents the right to receive up to 4 shares of our common stock upon achievement of certain performance goals during the performance period of July 1, 2012 through June 30, 2013. Shares of common stock earned, if any, under the Performance Awards will be issued in the third quarter of 2013 after our level of achievement of the performance goals has been determined (the "Determination Date"), with 25% of the shares being immediately vested and the remaining shares vesting 25% on each of the first three anniversaries of the Determination Date, subject to continuous employment of the participant through such dates. At June 30, 2013, the performance goals were achieved and each Performance Award will convert to 4 shares of our stock.

In February 2013, we granted 113,000 Performance Awards to designated participants under the 2011 Plan. These Performance Awards represent the right to receive up to 2.5 shares of our common stock upon achievement of certain performance goals during the performance period of January 1, 2013 through December 31, 2013. Shares of common stock earned, if any, under the Performance Awards will be issued in the first quarter of 2014 after we determine our level of achievement of the performance goals (the “2013 Award Determination Date”), with 25% of the shares being immediately vested and the remaining shares vesting with respect to 25% of the shares on each of the first three anniversaries of the 2013 Award Determination Date, subject to continuous employment of each participant through such dates. At June 30, 2013, we expect the performance goals will be achieved so that each Performance Award will convert to 1.7 shares of our common stock. No forfeitures are expected.

The following table summarizes our RSU and Performance Award activity:

	RSUs		Performance Awards	
	Number of Shares	Weighted Average Grant Date Fair Value Per Share	Number of Shares	Weighted Average Grant Date Fair Value Per Share
Outstanding at January 1, 2013	40,625	$8.90	588,000	$25.79
Granted	234,967	24.39	192,100	19.60
Released	(6,250)	8.90	—	—
Forfeited or expired	(2,830)	24.39	—	—
Outstanding at June 30, 2013	266,512	$22.39	780,100	$24.40
Ending vested and expected to vest at June 30, 2013	242,541		780,100	

RSUs that are expected to vest are net of estimated future forfeitures. RSUs released during the six months ended June 30, 2013 had an intrinsic value of $0.1 million and a grant-date fair value of $56,000. There were no RSUs released during the six months ended June 30, 2012. The number of RSUs released includes shares that we withheld on behalf of employees to satisfy the minimum statutory tax withholding requirements. There were 2,830 RSUs or Performance Awards forfeited or expired during the three and six months ended June 30, 2013.

As of June 30, 2013, total unrecognized compensation expense related to unvested RSUs and Performance Awards was $15.9 million and is expected to be recognized over a weighted average period of 2.8 years.

Employee Stock Purchase Plan

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For the three and six months ended June 30, 2013 and 2012, employees purchased 54,728 shares and 60,254 shares, respectively under the ESPP for a total of $0.9 million and $0.3 million, respectively. As of June 30, 2013, unrecognized compensation expense related to the current ESPP period which ends on August 30, 2013 is $0.1 million and is expected to be recognized over two months.

Valuation Information

The fair value of stock options and stock purchase rights granted under the 2009 Plan, the 2011 Plan and the ESPP were estimated at the date of grant using the Black-Scholes option valuation model with the following weighted average assumptions:

	Three months ended June 30,				Six months ended June 30,			
	2013		2012		2013		2012	
Stock option plans:								
Risk-free interest rate	0.96	%	0.90	%	0.96	%	1.03	%
Expected life of options (in years)	5.92		5.72		5.97		5.95	
Expected dividend yield	—	%	—	%	—	%	—	%
Volatility	52	%	57	%	52	%	56	%
Employee Stock Purchase Plan:								
Risk-free interest rate	0.13	%	0.15	%	0.13	%	0.15	%
Expected life of options (in years)	0.50		0.50		0.50		0.50	
Expected dividend yield	—	%	—	%	—	%	—	%
Volatility	37	%	47	%	37	%	47	%

Stock-based compensation expense during the three and six months ended June 30, 2013 and 2012 was recorded net of estimated forfeiture rates of 4.4% and 4.1%, respectively.

Common Stock

The following numbers of shares of common stock were reserved and available for future issuance at June 30, 2013:

	Reserved Shares
Options and awards outstanding under stock incentive plans	4,833,141
Shares available for future grant under the stock incentive plan	2,122,290
Shares available under the Employee Stock Purchase Plan	906,934
Total	7,862,365

In January 2013, 260,585 and 1,302,926 additional shares were reserved under the ESPP and the 2011 Plan, respectively, pursuant to the automatic increase provision in each respective plan.

NOTE 9—Segment Information

We operate in one industry—mortgage-related software and services. Our chief operating decision makers are our chief executive officer and president and chief operating officer, who make decisions about resource allocation and review financial information presented on a consolidated basis. Accordingly, we have determined that we have a single reporting segment and operating unit structure, specifically technology-enabled solutions to help streamline and automate the residential mortgage origination process for our network participants.

We are organized primarily on the basis of service lines. Supplemental disclosure of revenues by type is as follows:

	Three months ended June 30,		Six months ended June 30,	
	2013	2012	2013	2012
	(in thousands)			
On-demand revenues	$31,130	$20,400	$58,721	$38,155
On-premise revenues	3,140	3,169	6,404	6,320
	$34,270	$23,569	$65,125	$44,475

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

This Quarterly Report on Form 10-Q, including this Management's Discussion and Analysis of Financial Condition and Results of Operations, contains forward-looking statements within the meaning of Section 21E of the Securities Exchange Act of 1934, as amended, or the Exchange Act. These statements relate to future events or our future financial performance. Forward-looking statements may include words such as "may," "will," "should," "expect," "plan," "inte "anticipate," "believe," "estimate," "predict," "potential," "continue" or other wording indicating future results or expectations. Forward-looking statements are subject to risks and uncertainties and actual events or results may differ materially. Factors that could cause our actual results to differ materially include, but are not limited to, those discussed under "Risk Factors" in this report. We also face risks and uncertainties relating to our business including: the number of Encompass users; the effectiveness of our marketing and sales efforts to attract new and retain existing SaaS Encompass users and Ellie Mae Network participants; transaction volume on the Ellie Mae Network; the level of demand for our Encompass Docs Solution and other services we offer; the timing of the introduction and acceptance of new Ellie Mae Network offerings and new on-demand services; interruptions in Ellie Mae Network service, our hosted Encompass software and any related impact on our reputation; our ability to protect the confidential information of our Encompass users, Ellie Mae Network participants and their respective customers; customer renewal and upgrade rates; fluctuations in mortgage lending volume; the volume of mortgages originated by our Encompass users; the impact of changes in mortgage interest rates; changes in mortgage originator, lender, investor or service provider behavior and any related impact on the residential mortgage industry; our ability to accurately forecast revenues and appropriately plan our expenses; the increased time, cost and complexity that may be required to successfully target larger customers; our ability to scale our operations and increase productivity to support our existing and growing customer base; our ability to successfully manage our growth and any future acquisitions of businesses, solutions or technologies; the timing of future acquisitions of businesses, solutions or technologies and new product launches; the impact of uncertain domestic and worldwide economic conditions, including the resulting effect on residential mortgage volumes; changes in government regulation affecting Ellie Mae Network participants or our business, and potential structural changes in the U.S. residential mortgage industry; the attraction and retention of qualified employees and key personnel; our ability to compete effectively in a highly competitive market and adapt to technological changes; our ability to enhance the features and functionality of our Encompass software and the Ellie Mae Network; our ability to protect our intellectual property, including our proprietary Encompass software; costs associated with defending intellectual property infringement and other claims; our ability to maintain effective internal controls and the risk of natural and man-made catastrophic interruptions to our business. We undertake no obligation to revise or update any forward-looking statements to reflect any event or circumstance that arises after the date of this report, or to conform such statements to actual results or changes in our expectations.

This discussion should be read in conjunction with the condensed consolidated financial statements and notes presented in this Quarterly Report on Form 10-Q and the consolidated financial statements and notes in our Annual Report on Form 10-K for the year ended December 31, 2012, or 2012 Form 10-K.

Overview

We provide business automation software for a large segment of the residential mortgage industry in the United States. Our on-demand, technology-enabled software solutions help streamline and automate the process of originating and funding new mortgage loans, increasing efficiency, facilitating regulatory compliance and reducing documentation errors.

Mortgage originators use our Encompass360 software, a comprehensive operating system that handles key business and management functions involved in running a mortgage origination business. Mortgage originators use Encompass360 as a single tool for loan processing, marketing, customer communication and to interact electronically with lenders, investors and service providers over the Ellie Mae Network. It also enables enforcement of rules and business practices designed to ensure loan quality, adherence to processing standards and regulatory compliance.

We also offer Encompass360 users a variety of other on-demand software services, including: Encompass Docs Solution, which automatically prepares the disclosure and closing documents necessary to fund a mortgage; Encompass CenterWise, a bundled offering of electronic document management, or EDM, and websites used for customer relationship management; Total Quality Loan, or TQL, which offers a suite of fraud detection, valuation, validation and risk analysis services tailored to individual aggregator/investor requirements; Encompass Compliance Service, which automatically checks for compliance with federal, state and local regulations throughout the origination process; tax transcript services which provide income verification capability to our customers; and Encompass Product and Pricing Service, which allows Encompass360 users to compare loans offered by different lenders and investors to determine appropriate mortgage programs available to a particular borrower.

As of June 30, 2013, the Ellie Mae Network electronically connects the approximately 89,000 mortgage professionals using Encompass360 to the broad array of mortgage lenders, investors and third-party service providers integral to the origination and funding of residential mortgages. During the mortgage origination process, mortgage originators may order various services

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through the Ellie Mae Network, including credit reports, product eligibility and pricing, automated underwriting, secure data transmission to and from lenders and investors, appraisals, title reports, insurance, flood certifications, compliance review, fraud detection, document preparation and verification of income, identity and employment.

We were formed as a California corporation in 1997 and reincorporated in Delaware in November 2009. From inception through 2000, we developed consumer-facing websites and initial versions of our network. We launched our first transaction platform in late 2000, the present version of which is the Ellie Mae Network. In 2003, we introduced our internally developed loan origination software solution, the present version of which is Encompass360.

Our revenues consist of on-demand and on-premise revenues. On-demand revenues are generated primarily from software subscriptions we host that customers access through the Internet, including customers who pay fees based on the number of loans they fund, or success basis, subject to monthly base fees, which we refer to as Success-Based Pricing. On-demand revenues also include software services that are sold transactionally as well as Ellie Mae Network transaction fees paid by lender-investors, service providers and certain government-sponsored entities participating on the Ellie Mae Network. On-premise revenues are typically generated from customer-hosted software licenses and related implementations, training and maintenance services. For further discussion of the sources of our revenue and our revenue recognition policy, please see "Critical Accounting Policies and Estimates" in Part I, Item 7 of our 2012 Form 10-K.

Our on-demand revenues generally track the seasonality of the residential mortgage industry, typically, but not always, with increased activity in the second and third quarters and reduced activity in the first and fourth quarters as home buyers tend to purchase their homes during the spring and summer in order to move to a new home before the start of the school year. Approximately 50% of our revenue historically has been sensitive to factors that impact mortgage volumes, such as interest rate fluctuations, home sale activity and general economic conditions. Increases in mortgage interest rates could reduce the volume of new mortgages originated and, in particular, the volume of mortgage refinancings. For example, in the last two months of the second quarter of 2013, mortgage interest rates increased by approximately one percentage point, which impacted the number of transactions completed over the Ellie Mae Network as the number of mortgage applications decreased.

We are investing aggressively in initiatives that we believe will help us continue to grow our business and improve our products and services. During the second quarter of 2013, we accelerated our investment in our sales and client services capabilities, as well as in technology infrastructure to support our user seat additions and overall business growth. These investments included expanding our talent across the organization by hiring additional personnel especially for our client services and implementation teams, building out new office facilities and upgrading our telephony system.

The residential mortgage industry has undergone significant changes since 2007, largely in response to the hundreds of billions of dollars of loan defaults and massive losses suffered by lenders and investors. Our business strategy has evolved to address recent industry trends, including:

- expected lower lending volume;
- increased quality standards imposed by regulators, lenders and investors;
- increased regulation affecting lenders and investors;
- greater focus on operational efficiencies; and
- customers adopting multi-channel strategies

We are responding to these trends as follows:

Expected lower lending volume. Mortgage lending volumes are expected to be lower in 2013 as compared to 2012, as forecasted by Fannie Mae, Freddie Mac and the Mortgage Bankers Association. Since late 2009, we have focused our marketing and sales efforts on our on-demand SaaS Encompass360 offering, and particularly our SaaS Encompass360 Success-Based Pricing model, in contrast to our on-premise license model. In our on-demand SaaS Encompass360 offering, the customer does not pay the significant up-front licensing fee associated with our license model, which we believe is particularly attractive in the present climate of the residential mortgage origination market. Our SaaS Encompass360 Success-Based Pricing model builds on this value proposition by aligning customers' payments for our software solutions with their own receipts of revenues. Our focus on our SaaS Encompass360 offering is important in light of lower lending volumes because we typically generate greater revenues per user through our on-demand SaaS Encompass360 offering than through our on-premise license offering.

We are also focusing on increasing use of our Ellie Mae Network offerings and our other services, which were introduced from late 2009 through late 2011. These offerings include our TQL initiative, Encompass Compliance Services, Encompass Product and Pricing Services and Encompass Docs Solution. At June 30, 2013 and 2012, Encompass360 users employed the Ellie Mae Network to process on average approximately six and five transactions per loan file, respectively. By continuing to enhance our service offerings and encouraging providers of settlement services to deliver their services electronically through the Ellie Mae

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Network, we will continue to build value for Ellie Mae Network participants while increasing the number of transactions for which the Ellie Mae Network is used.

Increased quality standards imposed by regulators, lenders and investors. Encompass360 is designed to automate and streamline the process of originating mortgages to, among other things, satisfy increased quality requirements of investors. Relevant features of Encompass360 include enabling customers' management to impose processing rules and formats, providing milestone and process reminders, automated population of forms with accurate data, and accurate and automated transmission of loan files and data from originators to investors and lenders. Our TQL initiative is designed to further enhance the quality, compliance and saleability of loans that are originated through Encompass360, and at June 30, 2013, we had two TQL investor customers. TQL is intended to reduce the opportunities for errors in the process of transferring information from originator to investor and give investors confidence in the accuracy and regulatory compliance of the information that is underlying loan files.

Increased regulation affecting lenders and investors. Regulatory reforms have significantly increased the complexity and importance of regulatory compliance. We devote considerable resources to continually upgrading software to help customers address regulatory changes. We offer Encompass Compliance Service, which automatically checks loan files for compliance with the myriad of federal, state and local regulations and alerts users to possible violations of these regulations. In addition, we have a staff of attorneys and work with compliance experts who help assure that documents prepared using our software and the processes recommended by the Encompass360 workflow comply with applicable rules and regulations. We believe we are well position to help our customers with additional regulations from the Dodd-Frank Wall Street Reform and Consumer Protection Act, or Dodd-Frank Act, that will be effective in January 2014.

Greater focus on operational efficiencies. Mortgage originators experienced an approximately 40% increase in direct production costs per loan between 2009 and 2011[1], and we expect this trend to continue due to continued increased regulation and heightened quality standards. By automating many of the functions of mortgage origination, we enable our users to comply with regulations and process quality loans more efficiently and effectively. This reduces the cost of originating a loan and lowers the risk of buy back demands from investors resulting from poorly originated or documented loans and/or loans that fail to comply with applicable regulations.

With an eye towards providing customers with ever-greater tools to enhance efficiency, we will continue to develop new service offerings through the Ellie Mae Network and pursue adoption of our services through initiatives such as our TQL initiative. By integrating and expanding our current and new services, we will provide a more comprehensive benefit to our users.

In addition to providing efficiency-enhancing solutions, delivery of our Encompass360 software in an on-demand SaaS environment provides customers with the added benefits of lower up front implementation costs and reduced need for an infrastructure of servers, storage and network devices as well as providing access to the most current release of an application, periodic upgrades and regulatory updates.

Customers adopting multi-channel strategies. Customers are developing multi-channel strategies beyond a single retail, correspondent or wholesale channel in order to grow their businesses. The requirements of these different channels vary and in order to maintain a single operating system, customers must use a robust system with highly configurable functionality. We continually address the changing needs of our customers by developing and enhancing tools to allow for simplified and consistent regulatory compliance, enhanced system functionality for each channel and increased workflow flexibility.

Operating Metrics

Revenue per average active Encompass360 user and SaaS Encompass360 revenue per average active SaaS Encompass360 user are key operational metrics we use to evaluate our business, determine allocation of our resources and make decisions regarding corporate strategy. The revenue per average active Encompass360 user metric is calculated by dividing total revenues by average active Encompass360 users during the period. The SaaS Encompass360 revenue per average active SaaS Encompass360 user metric is calculated by dividing total SaaS Encompass360 revenues by average active SaaS Encompass360 users during the period. We focus on these metrics to determine our success in leveraging our user base to increase our revenues. We track active Encompass360 users and active SaaS Encompass360 users as well as related revenues generated by each group at the end of a period to gauge the degree of our market penetration.

The components used to calculate these metrics are defined below.

Active Encompass360 users. An Active Encompass360 user is a mortgage origination professional who has used Encompass360 at least once within a 90-day period preceding the measurement date. An Encompass360 user is a mortgage origination professional working at a mortgage lender, such as a mortgage bank, commercial bank, thrift or credit union, which sources and funds loans and generally sells these funded loans to investors; or a mortgage brokerage, which typically processes and submits loan files to a mortgage lender or mega lender that funds the loan.

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1 Mortgage Bankers Association, Annual Mortgage Bankers Performance Report 2011 Data, Net Loan Production Income and Expense, $ per loan, Copyright June 2012.

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Average active Encompass360 users. Average active Encompass360 users during a period is calculated by averaging the monthly active Encompass360 users during a period.
Active SaaS Encompass360 users. An active SaaS Encompass360 user is a mortgage origination professional who has used the SaaS Encompass360 system at least once within a 90-day period preceding the measurement date.
Average active SaaS Encompass360 users. Average active SaaS Encompass360 users during a period is calculated by averaging the monthly active SaaS Encompass360 users during a period.

The following table shows these operating metrics as of and for the three and six months ended June 30, 2013 and 2012:

	Three months ended June 30,		Six months ended June 30,	
	2013	2012	2013	2012
Revenues (in thousands):				
Total revenues	$34,270	$23,569	$65,125	$44,475
Total SaaS Encompass360 revenues	$18,608	$10,713	$35,090	$19,091
Users at end of period:				
Active Encompass360 users	88,688	62,487	88,688	62,487
Active SaaS Encompass360 users	55,952	32,114	55,952	32,114
Active SaaS Encompass360 users as a percentage of active Encompass360 users	63 %	51 %	63 %	51 %
Average users during period:				
Active Encompass360 users	86,045	61,394	82,144	59,167
Active SaaS Encompass360 users	53,376	31,171	49,622	29,349
Active SaaS Encompass360 users as a percentage of active Encompass360 users	62 %	51 %	60 %	50 %
Revenue per average user during period:				
Revenue per average active Encompass360 user	398	384	793	752
SaaS Encompass360 revenue per average active SaaS Encompass360 user	349	344	707	650

Basis of Presentation

General

Our consolidated financial statements include the accounts of Ellie Mae, Inc. and our wholly owned subsidiaries. All significant intercompany accounts and transactions have been eliminated upon consolidation.

Revenue Recognition

We generate primarily on-demand revenues and on-premise revenues. Sales taxes assessed by governmental authorities are excluded from revenue.

On-demand Revenues

On-demand revenues are revenues generated from software subscriptions we host that customers access through the Internet as well as revenues from a small number of customers that have opted to self-host a portion of the software but pay fees based on a per closed loan, or success, basis subject to monthly base fees, which we refer to as Success-Based Pricing. On-demand revenues are also comprised of software services sold transactionally and Ellie Mae Network transaction fees.

On-premise Revenues

On-premise revenues generally are revenues generated from customer-hosted software licenses and related implementation (except for customer-hosted Success-Based Pricing revenues included in on-demand revenues described above), training and maintenance services.

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Cost of Revenues and Operating Expenses

Cost of Revenues

Our cost of revenues consists primarily of: salaries and benefits, including stock-based compensation; royalty expenses for document preparation, income verification and compliance services; customer support; data centers; depreciation on computer equipment used in supporting our hosted software solutions; amortization of acquired intangible assets; professional services associated with implementation of our software; and allocated facilities costs. We expect that our cost of revenues will continue to increase in absolute dollars as our revenues increase, as we make additional investments in our technology infrastructure and as we continue to hire additional personnel in our SaaS operations, professional services and customer support departments to support new customers and new service offerings.

Sales and Marketing

Our sales and marketing expenses consist primarily of: salaries, benefits and incentive compensation, including stock-based compensation and commissions; allocated facilities costs; expenses for trade shows, public relations and other promotional and marketing activities; expenses for travel and entertainment; and amortization of acquired intangible assets such as customer lists and contracts. We expect that our sales and marketing expense will continue to increase in absolute dollars as increased revenues generate additional commission expense and as we continue to hire additional sales personnel in order to address anticipated demand for our software solutions as we expect an increased number of mortgage lenders to assess new platform options and replace their legacy systems. We also intend to increase marketing activities focused on SaaS Encompass360, our Ellie Mae Network offerings and our other Encompass services.

Research and Development

Our research and development expenses consist primarily of: salaries and benefits, including bonuses and stock-based compensation; fees to contractors engaged in the development and support of the Ellie Mae Network infrastructure, Encompass360 software and other products; and allocated facilities costs. We expect that our research and development expenses will continue to increase in absolute dollars as we continue to invest in our products and services and infrastructure, including hiring additional engineering and product development personnel.

General and Administrative

Our general and administrative expenses consist primarily of: salaries and benefits, including bonuses and stock-based compensation, for employees involved in finance, accounting, human resources, administrative and legal roles; consulting, legal, accounting and other professional services by third-party providers; and allocated facilities costs. We expect general and administrative expenses in 2013 to exceed those in 2012 both in absolute dollars and as a percentage of revenues with a significant increase related to greater amounts of stock-based compensation expense relating to awards granted to attract and retain employees as well as increases in headcount and facilities to support the continued growth of our business.

Other Income (Expense), Net

Other income (expense), net consists primarily of interest income earned on investments, cash accounts and notes receivable, offset by investment premium amortization and imputed interest expense related to the Del Mar Datatrac, Inc., or DMD, acquisition holdback payments and interest expense paid on equipment and software leases.

Income Taxes

On a quarterly basis, we evaluate our expected income tax expense or benefit based on our year-to-date operations, and we record an adjustment in the current quarter. The net tax provision is the result of the mix of profits earned by us and our subsidiaries in tax jurisdictions with a broad range of income tax rates. We are required to estimate deferred tax assets and liabilities based on the differences between the financial reporting and tax bases of assets and liabilities measured using the enacted tax rates that will be in effect when the differences are expected to reverse. In general, deferred tax assets represent future tax benefits to be received when certain expenses previously recognized in our consolidated statements of operations become deductible expenses under applicable income tax laws or loss or credit carry forwards are utilized. Accordingly, realization of our deferred tax assets is dependent on future taxable income against which these deductions, losses and credits can be utilized. We use management judgment to assess the likelihood that our deferred tax assets will be recovered from future taxable income and to the extent we believe that recovery is not more likely than not, we must establish a valuation allowance to reduce the deferred tax assets to the amount that is more likely than not to be realized.

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Critical Accounting Policies and Estimates

Deferred Commissions

Deferred commission expenses are the incremental costs that are directly associated with non-cancelable subscription contracts with customers and consist of sales commissions paid to our direct sales force. Commissions are calculated based on a percentage of the revenue for the non-cancelable term of subscription contracts, which are typically one to five years.

Prior to 2013, commissions were paid and recognized as sales expense when customer payments for contracted services were received on a monthly basis because commissions were earned based on receipt of customer payments. In 2013, we amended our commission plans to provide for payment after the customer's contract is signed. As a result of the change in commission plans, beginning in 2013, commission expense is deferred and amortized to sales expense over the non-cancelable terms of the related subscription contracts. The deferred commission expense amounts are recoverable through the future revenue streams under the non-cancelable customer contracts. The new plans also include claw back provisions, which allow for repayment of a proportionate amount of commissions, should customers cancel their contracts prior to the end of the initial contractual term.

There have been no other material changes during the three and six months ended June 30, 2013 to our critical accounting policies and estimates previously disclosed in our 2012 Form 10-K.

Results of Operations

The following tables set forth our results of operations for the periods presented and as a percentage of our revenues for those periods. The period-to-period comparison of financial results is not necessarily indicative of future results.

	Three months ended June 30,		Six months ended June 30,	
	2013	2012	2013	2012
	(in thousands)			
Revenues	$34,270	$23,569	$65,125	$44,475
Cost of revenues (1)	8,607	5,283	16,218	10,540
Gross profit	25,663	18,286	48,907	33,935
Operating expenses:				
Sales and marketing (1)	5,167	4,232	10,070	8,232
Research and development (1)	6,530	4,299	12,078	8,432
General and administrative (1)	7,975	4,496	15,561	8,172
Total operating expenses	19,672	13,027	37,709	24,836
Income from operations	5,991	5,259	11,198	9,099
Other income (expense), net	151	(18)	272	(38)
Income before income taxes	6,142	5,241	11,470	9,061