

**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION**
Washington, D.C. 20549

FORM 10-Q

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

For the Quarterly Period Ended September 30, 2019

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 0-21886

BARRETT BUSINESS SERVICES, INC.

(Exact name of registrant as specified in its charter)

Maryland
(State or other jurisdiction of
Incorporation or organization)

8100 NE Parkway Drive, Suite 200
Vancouver, Washington
(Address of principal executive offices)

52-0812977
(IRS Employer
Identification No.)

98662
(Zip Code)

(360) 828-0700

(Registrant's telephone number, including area code)

Securities registered pursuant to Section 12(b) of the Act:

| Title of each class | Trading Symbol(s) | Name of each exchange on which registered |
|--|-------------------|---|
| Common Stock, Par Value \$0.01 Per Share | BBSI | The NASDAQ Stock Market LLC |

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

Indicate by check mark whether the registrant has submitted electronically every Interactive Data File required to be submitted 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 such files). Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, 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 | <input type="checkbox"/> | Accelerated filer | <input checked="" type="checkbox"/> |
| Non-accelerated filer | <input type="checkbox"/> | Smaller reporting company | <input type="checkbox"/> |
| | | Emerging growth company | <input type="checkbox"/> |

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

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

As of November 1, 2019, 7,494,281 shares of the registrant's common stock (\$0.01 par value) were outstanding.

BARRETT BUSINESS SERVICES, INC.

INDEX TO FORM 10-Q

Part I - Financial Information (Unaudited)

| | <u>Page</u> |
|---|-------------|
| Item 1. Unaudited Interim Condensed Consolidated Financial Statements | |
| Condensed Consolidated Balance Sheets - September 30, 2019 and December 31, 2018 | 3 |
| Condensed Consolidated Statements of Operations - Three and Nine Months Ended September 30, 2019 and 2018 | 4 |
| Condensed Consolidated Statements of Comprehensive Income - Three and Nine Months Ended September 30, 2019 and 2018 | 5 |
| Condensed Consolidated Statements of Stockholders' Equity - Three and Nine Months Ended September 30, 2018 | 6 |
| Condensed Consolidated Statements of Stockholders' Equity - Three and Nine Months Ended September 30, 2019 | 7 |
| Condensed Consolidated Statements of Cash Flows - Nine Months Ended September 30, 2019 and 2018 | 8 |
| Notes to Condensed Consolidated Financial Statements | 9 |
| Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations | 23 |
| Item 3. Quantitative and Qualitative Disclosures About Market Risk | 30 |
| Item 4. Controls and Procedures | 30 |

Part II - Other Information

| | |
|---|----|
| Item 1. Legal Proceedings | 31 |
| Item 1A. Risk Factors | 31 |
| Item 6. Exhibits | 32 |

| | |
|---------------------------|----|
| Signature | 33 |
|---------------------------|----|

PART I – FINANCIAL INFORMATION

Item 1. Unaudited Interim Condensed Consolidated Financial Statements

Barrett Business Services, Inc.
Condensed Consolidated Balance Sheets
(Unaudited)
(In Thousands, Except Par Value)

| | September 30, 2019 | December 31, 2018 |
|--|-----------------------|----------------------|
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 35,452 | \$ 35,371 |
| Investments | 101,748 | 416 |
| Trade accounts receivable, net | 187,467 | 151,597 |
| Prepaid expenses and other | 15,974 | 13,880 |
| Restricted cash and investments | 107,702 | 120,409 |
| Total current assets | <u>448,343</u> | <u>321,673</u> |
| Investments | — | 1,687 |
| Property, equipment and software, net | 29,575 | 24,812 |
| Operating lease right-of-use assets | 23,784 | — |
| Restricted cash and investments | 311,882 | 348,165 |
| Goodwill | 47,820 | 47,820 |
| Other assets | 3,253 | 3,474 |
| Deferred income taxes | 5,523 | 8,458 |
| | <u>\$ 870,180</u> | <u>\$ 756,089</u> |
| LIABILITIES AND STOCKHOLDERS' EQUITY | | |
| Current liabilities: | | |
| Current portion of long-term debt | \$ 221 | \$ 221 |
| Accounts payable | 5,432 | 4,336 |
| Accrued payroll, payroll taxes and related benefits | 197,686 | 158,683 |
| Income taxes payable | 3,408 | 4,403 |
| Current operating lease liabilities | 6,448 | — |
| Other accrued liabilities | 13,244 | 20,566 |
| Workers' compensation claims liabilities | 113,623 | 109,319 |
| Safety incentives liability | 27,727 | 29,210 |
| Total current liabilities | <u>367,789</u> | <u>326,738</u> |
| Long-term workers' compensation claims liabilities | 316,423 | 304,078 |
| Long-term debt | 3,785 | 3,951 |
| Long-term operating lease liabilities | 17,906 | — |
| Customer deposits and other long-term liabilities | 4,106 | 2,285 |
| Total liabilities | <u>710,009</u> | <u>637,052</u> |
| Commitments and contingencies (Notes 4, 5 and 7) | | |
| Stockholders' equity: | | |
| Common stock, \$.01 par value; 20,500 shares authorized, 7,494 and 7,395 shares issued and outstanding | 75 | 74 |
| Additional paid-in capital | 18,259 | 15,437 |
| Accumulated other comprehensive income (loss) | 2,619 | (5,068) |
| Retained earnings | 139,218 | 108,594 |
| Total stockholders' equity | <u>160,171</u> | <u>119,037</u> |
| | <u>\$ 870,180</u> | <u>\$ 756,089</u> |

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

Barrett Business Services, Inc.
Condensed Consolidated Statements of Operations
(Unaudited)
(In Thousands, Except Per Share Amounts)

| | Three Months Ended | | Nine Months Ended | |
|--|--------------------|------------------|-------------------|------------------|
| | September 30, | | September 30, | |
| | 2019 | 2018 | 2019 | 2018 |
| Revenues: | | | | |
| Professional employer service fees | \$ 214,156 | \$ 206,320 | \$ 607,840 | \$ 592,559 |
| Staffing services | 33,806 | 40,967 | 89,319 | 110,307 |
| Total revenues | <u>247,962</u> | <u>247,287</u> | <u>697,159</u> | <u>702,866</u> |
| Cost of revenues: | | | | |
| Direct payroll costs | 25,464 | 30,842 | 67,298 | 83,265 |
| Payroll taxes and benefits | 104,847 | 100,348 | 321,341 | 322,784 |
| Workers' compensation | 46,887 | 56,412 | 154,290 | 172,388 |
| Total cost of revenues | <u>177,198</u> | <u>187,602</u> | <u>542,929</u> | <u>578,437</u> |
| Gross margin | 70,764 | 59,685 | 154,230 | 124,429 |
| Selling, general and administrative expenses | 41,352 | 36,670 | 113,517 | 101,713 |
| Depreciation and amortization | 970 | 949 | 2,909 | 3,228 |
| Income from operations | <u>28,442</u> | <u>22,066</u> | <u>37,804</u> | <u>19,488</u> |
| Other income (expense): | | | | |
| Investment income, net | 2,882 | 2,235 | 9,286 | 6,455 |
| Interest expense | (394) | (465) | (1,352) | (574) |
| Other, net | — | 10 | 12 | 15 |
| Other income, net | 2,488 | 1,780 | 7,946 | 5,896 |
| Income before income taxes | 30,930 | 23,846 | 45,750 | 25,384 |
| Provision for income taxes | 5,959 | 4,759 | 9,172 | 4,178 |
| Net income | <u>\$ 24,971</u> | <u>\$ 19,087</u> | <u>\$ 36,578</u> | <u>\$ 21,206</u> |
| Basic income per common share | <u>\$ 3.34</u> | <u>\$ 2.59</u> | <u>\$ 4.92</u> | <u>\$ 2.89</u> |
| Weighted average number of basic common shares outstanding | <u>7,483</u> | <u>7,369</u> | <u>7,433</u> | <u>7,327</u> |
| Diluted income per common share | <u>\$ 3.24</u> | <u>\$ 2.50</u> | <u>\$ 4.76</u> | <u>\$ 2.77</u> |
| Weighted average number of diluted common shares outstanding | <u>7,711</u> | <u>7,643</u> | <u>7,686</u> | <u>7,652</u> |

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

Barrett Business Services, Inc.
Condensed Consolidated Statements of Comprehensive Income
(Unaudited)
(In Thousands)

| | Three Months Ended September 30, | |
|--|-------------------------------------|-----------|
| | 2019 | 2018 |
| Net income | \$ 24,971 | \$ 19,087 |
| Unrealized gains (losses) on investments, net of tax of \$376 and (\$396) in 2019 and 2018, respectively | 987 | (1,037) |
| Comprehensive income | \$ 25,958 | \$ 18,050 |

| | Nine Months Ended September 30, | |
|--|------------------------------------|-----------|
| | 2019 | 2018 |
| Net income | \$ 36,578 | \$ 21,206 |
| Unrealized gains (losses) on investments, net of tax of \$2,935 and (\$2,325) in 2019 and 2018, respectively | 7,687 | (5,976) |
| Comprehensive income | \$ 44,265 | \$ 15,230 |

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

Barrett Business Services, Inc.
Condensed Consolidated Statements of Stockholders' Equity
Three and Nine Months Ended September 30, 2018
(Unaudited)
(In Thousands)

| | Common Stock | | Additional Paid-in Capital | Accumulated Other Comprehensive (Loss) Income | Retained Earnings | Total |
|--|--------------|--------------|----------------------------------|---|----------------------|------------------|
| | Shares | Amount | | | | |
| Balance, December 31, 2017 | 7,301 | \$ 73 | \$ 12,311 | \$ (1,430) | \$ 77,880 | \$ 88,834 |
| Common stock issued on exercise of options and vesting of restricted stock units | 7 | — | 53 | — | — | 53 |
| Common stock repurchased on vesting of restricted stock units | (1) | — | (76) | — | — | (76) |
| Share-based compensation expense | — | — | 1,542 | — | — | 1,542 |
| Cash dividends on common stock (\$0.25 per share) | — | — | — | — | (1,826) | (1,826) |
| Unrealized loss on investments, net of tax | — | — | — | (3,964) | — | (3,964) |
| Net loss | — | — | — | — | (9,123) | (9,123) |
| Balance, March 31, 2018 | <u>7,307</u> | <u>\$ 73</u> | <u>\$ 13,830</u> | <u>\$ (5,394)</u> | <u>\$ 66,931</u> | <u>\$ 75,440</u> |
| Common stock issued on exercise of options and vesting of restricted stock units | 5 | — | 48 | — | — | 48 |
| Common stock repurchased on vesting of restricted stock units | (1) | — | (92) | — | — | (92) |
| Share-based compensation expense | — | — | 1,041 | — | — | 1,041 |
| Cash dividends on common stock (\$0.25 per share) | — | — | — | — | (1,827) | (1,827) |
| Unrealized loss on investments, net of tax | — | — | — | (975) | — | (975) |
| Net income | — | — | — | — | 11,240 | 11,240 |
| Balance, June 30, 2018 | <u>7,311</u> | <u>\$ 73</u> | <u>\$ 14,827</u> | <u>\$ (6,369)</u> | <u>\$ 76,344</u> | <u>\$ 84,875</u> |
| Common stock issued on exercise of options and vesting of restricted stock units | 100 | 1 | 222 | — | — | 223 |
| Common stock repurchased on vesting of restricted stock units | (30) | — | (2,784) | — | — | (2,784) |
| Share-based compensation expense | — | — | 1,409 | — | — | 1,409 |
| Cash dividends on common stock (\$0.25 per share) | — | — | — | — | (1,844) | (1,844) |
| Unrealized loss on investments, net of tax | — | — | — | (1,037) | — | (1,037) |
| Net income | — | — | — | — | 19,087 | 19,087 |
| Balance, September 30, 2018 | <u>7,381</u> | <u>\$ 74</u> | <u>\$ 13,674</u> | <u>\$ (7,406)</u> | <u>\$ 93,587</u> | <u>\$ 99,929</u> |

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

Barrett Business Services, Inc.
Condensed Consolidated Statements of Stockholders' Equity
Three and Nine Months Ended September 30, 2019
(Unaudited)
(In Thousands)

| | Common Stock | | Additional Paid-in Capital | Accumulated Other Comprehensive (Loss) Income | Retained Earnings | Total |
|---|--------------|--------------|----------------------------------|---|----------------------|-------------------|
| | Shares | Amount | | | | |
| Balance, December 31, 2018 | 7,395 | \$ 74 | \$ 15,437 | \$ (5,068) | \$ 108,594 | \$ 119,037 |
| Common stock issued on exercise of options and vesting of restricted stock units and performance awards | 17 | — | 122 | — | — | 122 |
| Common stock repurchased on vesting of restricted stock units and performance awards | (2) | — | (178) | — | — | (178) |
| Share-based compensation expense | — | — | 1,387 | — | — | 1,387 |
| Cash dividends on common stock (\$0.25 per share) | — | — | — | — | (1,852) | (1,852) |
| Unrealized gain on investments, net of tax | — | — | — | 3,657 | — | 3,657 |
| Net loss | — | — | — | — | (2,300) | (2,300) |
| Balance, March 31, 2019 | <u>7,410</u> | <u>\$ 74</u> | <u>\$ 16,768</u> | <u>\$ (1,411)</u> | <u>\$ 104,442</u> | <u>\$ 119,873</u> |
| Common stock issued on exercise of options and vesting of restricted stock units | 4 | — | 56 | — | — | 56 |
| Share-based compensation expense | — | — | 2,441 | — | — | 2,441 |
| Cash dividends on common stock (\$0.25 per share) | — | — | — | — | (1,853) | (1,853) |
| Unrealized gain on investments, net of tax | — | — | — | 3,043 | — | 3,043 |
| Net income | — | — | — | — | 13,907 | 13,907 |
| Balance, June 30, 2019 | <u>7,414</u> | <u>\$ 74</u> | <u>\$ 19,265</u> | <u>\$ 1,632</u> | <u>\$ 116,496</u> | <u>\$ 137,467</u> |
| Common stock issued on exercise of options and vesting of restricted stock units | 116 | 1 | 279 | — | — | 280 |
| Common stock repurchased on vesting of restricted stock units | (36) | — | (2,958) | — | — | (2,958) |
| Share-based compensation expense | — | — | 1,673 | — | — | 1,673 |
| Cash dividends on common stock (\$0.30 per share) | — | — | — | — | (2,249) | (2,249) |
| Unrealized gain on investments, net of tax | — | — | — | 987 | — | 987 |
| Net income | — | — | — | — | 24,971 | 24,971 |
| Balance, September 30, 2019 | <u>7,494</u> | <u>\$ 75</u> | <u>\$ 18,259</u> | <u>\$ 2,619</u> | <u>\$ 139,218</u> | <u>\$ 160,171</u> |

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

Barrett Business Services, Inc.
Condensed Consolidated Statements of Cash Flows
(Unaudited)
(In Thousands)

| | Nine Months Ended September 30, | |
|---|------------------------------------|-------------------|
| | 2019 | 2018 |
| Cash flows from operating activities: | | |
| Net income | \$ 36,578 | \$ 21,206 |
| Reconciliations of net income to net cash provided by operating activities: | | |
| Depreciation and amortization | 2,909 | 3,228 |
| Non-cash lease expense | 5,243 | — |
| Investment (accretion) amortization and (gains) losses recognized | 940 | 36 |
| Share-based compensation | 5,501 | 3,992 |
| Changes in certain operating assets and liabilities: | | |
| Trade accounts receivable | (35,870) | (25,910) |
| Income taxes receivable | — | 1,686 |
| Prepaid expenses and other | (2,094) | (6,720) |
| Accounts payable | 1,096 | (702) |
| Accrued payroll, payroll taxes and related benefits | 40,763 | 13,079 |
| Other accrued liabilities | (7,322) | (772) |
| Income taxes payable | (995) | 2,429 |
| Workers' compensation claims liabilities | 16,857 | 35,391 |
| Safety incentives liability | (1,483) | 68 |
| Operating lease liabilities | (4,673) | — |
| Other assets and liabilities, net | 75 | (109) |
| Net cash provided by operating activities | <u>57,525</u> | <u>46,902</u> |
| Cash flows from investing activities: | | |
| Purchase of property and equipment | (7,672) | (4,442) |
| Purchase of investments | (658) | (1,688) |
| Proceeds from sales and maturities of investments | 15,941 | 1,481 |
| Purchase of restricted investments | (3,946) | (103,861) |
| Proceeds from sales and maturities of restricted investments | 42,409 | 54,819 |
| Net cash provided by (used in) investing activities | <u>46,074</u> | <u>(53,691)</u> |
| Cash flows from financing activities: | | |
| Proceeds from credit-line borrowings | 18,843 | 8,500 |
| Payments on credit-line borrowings | (18,843) | (8,500) |
| Payments on long-term debt | (166) | (165) |
| Common stock repurchased on vesting of stock awards | (3,136) | (2,952) |
| Dividends paid | (5,954) | (5,499) |
| Proceeds from exercise of stock options | 458 | 324 |
| Net cash used in financing activities | <u>(8,798)</u> | <u>(8,292)</u> |
| Net increase (decrease) in cash, cash equivalents and restricted cash | 94,801 | (15,081) |
| Cash, cash equivalents and restricted cash, beginning of period | 140,702 | 120,205 |
| Cash, cash equivalents and restricted cash, end of period | <u>\$ 235,503</u> | <u>\$ 105,124</u> |

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

Barrett Business Services, Inc.
Notes to Condensed Consolidated Financial Statements
(Unaudited)

Note 1 - Basis of Presentation of Interim Period Statements

The accompanying condensed consolidated financial statements are unaudited and have been prepared by Barrett Business Services, Inc. ("BBSI", the "Company", "our" or "we"), pursuant to the rules and regulations of the Securities and Exchange Commission. Certain information and note disclosures typically included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America ("GAAP") have been condensed or omitted pursuant to such rules and regulations. In the opinion of management, the condensed consolidated financial statements include all adjustments, consisting only of normal recurring adjustments, necessary for a fair statement of the results for the interim periods presented. The accompanying condensed financial statements are prepared on a consolidated basis. All intercompany account balances and transactions have been eliminated in consolidation. The preparation of condensed consolidated financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the amounts reported in the condensed consolidated financial statements and accompanying notes. Actual results may differ from such estimates and assumptions. The condensed consolidated financial statements should be read in conjunction with the audited consolidated financial statements and notes thereto included in the Company's 2018 Annual Report on Form 10-K at pages F1 – F27. The results of operations for an interim period are not necessarily indicative of the results of operations for a full year.

Revenue recognition

Professional employer ("PEO") services are normally used by organizations to satisfy ongoing needs related to the management of human capital and are governed by the terms of a client services agreement which covers all employees at a particular work site. Staffing revenues relate primarily to short-term staffing, contract staffing and on-site management services. The Company's performance obligations for PEO and staffing services are satisfied, and the related revenue is recognized, as services are rendered by our workforce.

Our PEO client service agreements have a minimum term of one year, are renewable on an annual basis, and typically require 30 days' written notice to cancel or terminate the contract by either party. In addition, our client service agreements provide for immediate termination upon any default of the client regardless of when notice is given. PEO customers are invoiced following the end of each payroll processing cycle, with payment generally due on the invoice date. Staffing customers are invoiced weekly based on agreed rates per employee and actual hours worked, typically with payment terms of 30 days. The amount of earned but unbilled revenue is classified as a receivable on the condensed consolidated balance sheets.

We report PEO revenues net of direct payroll costs because we are not the primary obligor for these payments to our clients' employees. Direct payroll costs include salaries, wages, health insurance, and employee out-of-pocket expenses incurred incidental to employment. We also present revenue net of customer incentives, including safety incentives, because those incentives represent consideration payable to customers.

Cost of revenues

Our cost of revenues for PEO services includes employer payroll-related taxes and workers' compensation costs. Our cost of revenues for staffing services includes direct payroll costs, employer payroll-related taxes, employee benefits, and workers' compensation costs. Direct payroll costs represent the gross payroll earned by staffing services employees based on salary or hourly wages. Payroll taxes and employee benefits consist of the employer's portion of Social Security and Medicare taxes, federal and state unemployment taxes, and staffing services employee reimbursements for materials, supplies and other expenses, which are paid by our customer. Workers' compensation costs consist primarily of claims reserves, claims administration fees, legal fees, medical cost containment ("MCC") expense, state administrative agency fees, third-party broker commissions, risk manager payroll, premiums for excess insurance, and the fronted insurance program, as well as costs associated with operating our two wholly owned insurance companies, Associated Insurance Company for Excess ("AICE") and Ecole Insurance Company ("Ecole").

Cash and cash equivalents

We consider non-restricted short-term investments that are highly liquid, readily convertible into cash, and have maturities at acquisition of less than three months, to be cash equivalents for purposes of the condensed consolidated statements of cash flows and condensed consolidated balance sheets. The Company maintains cash balances in bank accounts that normally exceed FDIC insured limits. The Company has not experienced any losses related to its cash concentration.

Investments

The Company classifies investments as available-for-sale. The Company's investments are reported at fair value with unrealized gains and losses, net of taxes, shown as a component of accumulated other comprehensive income (loss) in stockholders' equity. Investments are recorded as current on the condensed consolidated balance sheets as the invested funds are available for current operations. Management considers available evidence in evaluating potential impairment of investments, including the duration and extent to which fair value is less than cost. Realized gains and losses on sales of investments are included in investment income in our condensed consolidated statements of operations. In the event a loss is determined to be other-than-temporary, the loss will be recognized in the condensed consolidated statements of operations.

Restricted cash and investments

The Company holds restricted cash and investments primarily for the future payment of workers' compensation claims. These investments are categorized as available-for-sale. They are reported at fair value with unrealized gains and losses, net of taxes, shown as a component of accumulated other comprehensive income (loss) in stockholders' equity. Restricted cash and investments are classified as current and noncurrent on the condensed consolidated balance sheets based on the nature of the restriction. Management considers available evidence in evaluating potential impairment of restricted investments, including the duration and extent to which fair value is less than cost. Realized gains and losses on sales of restricted investments are included in investment income in our condensed consolidated statements of operations. In the event a loss is determined to be other-than-temporary, the loss will be recognized in the condensed consolidated statements of operations.

Restricted cash and investments also includes investments held as part of the Company's deferred compensation plan. These investments are classified as trading securities and are recorded at fair value with unrealized gains and losses reported as a component of other income (expense), net.

Allowance for doubtful accounts

The Company had an allowance for doubtful accounts of \$774,000 and \$533,000 at September 30, 2019 and December 31, 2018, respectively. We make estimates of the collectability of our accounts receivable for services provided to our customers. Management analyzes historical bad debts, customer concentrations, customer credit-worthiness, current economic trends and changes in customers' payment trends when evaluating the adequacy of the allowance for doubtful accounts. If the financial condition of our customers deteriorates, resulting in an impairment of their ability to make payments, additional allowances may be required.

Workers' compensation claims liabilities

Our workers' compensation claims liabilities do not represent an exact calculation of liability but rather management's best estimate, utilizing actuarial expertise and projection techniques, at a given reporting date. The estimated liability for open workers' compensation claims is based on an evaluation of information provided by our third-party administrators for workers' compensation claims, coupled with an actuarial estimate of future adverse loss development with respect to reported claims and incurred but not reported claims (together, "IBNR"). Workers' compensation claims liabilities include case reserve estimates for reported losses, plus additional amounts for estimated IBNR claims, MCC and legal costs, and unallocated loss adjustment expenses. The estimate of incurred costs expected to be paid within one year is included in current liabilities, while the estimate of incurred costs expected to be paid beyond one year is included in long-term liabilities on our condensed consolidated balance sheets. These estimates are reviewed at least quarterly and adjustments to estimated liabilities are reflected in current operating results as they become known.

The process of arriving at an estimate of unpaid claims and claims adjustment expense involves a high degree of judgment and is affected by both internal and external events, including changes in claims handling practices, changes in reserve estimation procedures, inflation, trends in the litigation and settlement of pending claims, and legislative changes.

Our estimates are based on informed judgment, derived from individual experience and expertise applied to multiple sets of data and analyses. We consider significant facts and circumstances known both at the time that loss reserves are initially established and as new facts and circumstances become known. Due to the inherent uncertainty underlying loss reserve estimates, the expenses incurred through final resolution of our liability for our workers' compensation claims will likely vary from the related loss reserves at the reporting date. Therefore, as specific claims are paid out in the future, actual paid losses may be materially different from our current loss reserves.

A basic premise in most actuarial analyses is that historical data and past patterns demonstrated in the incurred and paid historical data form a reasonable basis upon which to project future outcomes, absent a material change. Significant structural changes to the available data can materially impact the reserve estimation process. To the extent a material change affecting the ultimate claim liability becomes known, such change is quantified to the extent possible through an analysis of internal Company data and, if available and when appropriate, external data. Nonetheless, actuaries exercise a considerable degree of judgment in the evaluation of these factors and the need for such actuarial judgment is more pronounced when faced with material uncertainties.

Customer incentives

We accrue for and present expected customer incentives as a reduction of revenue. Safety incentives represent cash incentives paid to certain PEO client companies for maintaining safe-work practices and minimizing workplace injuries. The incentive is based on a percentage of annual payroll and is paid annually to customers who meet predetermined workers' compensation claims cost objectives. Safety incentive payments are made only after closure of all workers' compensation claims incurred during the customer's contract period. The safety incentive liability is estimated and accrued each month based upon contract year-to-date payroll and the then current amount of the customer's estimated workers' compensation claims reserves as established by us and our third party administrator. The Company provided \$27.7 million and \$29.2 million at September 30, 2019 and December 31, 2018, respectively, as an estimate of the liability for unpaid safety incentives. Also, a one-time customer incentive of \$9.8 million was declared in December 2018 and is included in other accrued liabilities on the consolidated balance sheets. At September 30, 2019 the remaining unpaid amount of this incentive was \$5.0 million.

Customer deposits

We require deposits from certain PEO customers to cover a portion of our accounts receivable due from such customers in the event of default of payment.

Comprehensive income (loss)

Comprehensive income (loss) includes all changes in equity during a period except those that resulted from investments by or distributions to the Company's stockholders.

Other comprehensive income (loss) refers to revenues, expenses, gains and losses that under U.S. generally accepted accounting principles ("GAAP") are included in comprehensive income (loss), but excluded from net income (loss) as these amounts are recorded directly as an adjustment to stockholders' equity. Our other comprehensive income (loss) comprises unrealized holding gains and losses on our available-for-sale investments.

Statements of cash flows

Interest paid during the nine months ended September 30, 2019 did not materially differ from interest expense. Interest paid during the nine months ended September 30, 2018 totaled \$1.8 million, primarily related to prepaid fees for the Company's letter of credit. Income taxes paid during the nine months ended September 30, 2019 totaled \$10.1 million. Income taxes paid during the nine months ended September 30, 2018 totaled \$0.1 million.

Bank deposits and other cash equivalents that are restricted for use are classified as restricted cash. The table below reconciles the cash, cash equivalents and restricted cash balances from our condensed consolidated balance sheets to the amounts reported on the condensed consolidated statements of cash flows (in thousands):

| | September 30, 2019 | December 31, 2018 | September 30, 2018 | December 31, 2017 |
|---|-----------------------|----------------------|-----------------------|----------------------|
| Cash and cash equivalents | \$ 35,452 | \$ 35,371 | \$ 34,975 | \$ 59,835 |
| Restricted cash, included in restricted cash and investments | 200,051 | 105,331 | 70,149 | 60,370 |
| Total cash, cash equivalents and restricted cash shown in the statement of cash flows | <u>\$ 235,503</u> | <u>\$ 140,702</u> | <u>\$ 105,124</u> | <u>\$ 120,205</u> |

Basic and diluted earnings per share

Basic earnings per share are computed based on the weighted average number of common shares outstanding for each year using the treasury method. Diluted earnings per share reflect the potential effects of the exercise of outstanding stock options and the issuance of stock associated with outstanding restricted stock units. Basic and diluted shares outstanding are summarized as follows (in thousands):

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|-------------------------------------|--------------|------------------------------------|--------------|
| | 2019 | 2018 | 2019 | 2018 |
| Weighted average number of basic shares outstanding | 7,483 | 7,369 | 7,433 | 7,327 |
| Effect of dilutive securities | 228 | 274 | 253 | 325 |
| Weighted average number of diluted shares outstanding | <u>7,711</u> | <u>7,643</u> | <u>7,686</u> | <u>7,652</u> |

Accounting estimates

The preparation of our 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 condensed consolidated financial statements and the reported amounts of revenues and expenses during the reporting periods. Management bases its estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Estimates are used for fair value measurement of investments, allowance for doubtful accounts, deferred income taxes, carrying values for goodwill and property and equipment, accrued workers' compensation liabilities and customer incentive liabilities. Actual results may or may not differ from such estimates.

Recent accounting pronouncements

In February 2016, the Financial Accounting Standards Board ("FASB") issued ASU No. 2016-02, "Leases." The core principle is that a lessee should recognize the assets and liabilities that arise from leases, including operating leases. Under the new guidance, a lessee should recognize in the statement of financial position a liability to make lease payments (the lease liability) and a right-of-use asset representing its right to use the underlying asset for the lease term. For leases with a term of 12 months or less, a lessee is permitted to make an accounting policy election by class of underlying asset not to recognize lease assets and lease liabilities. The amendments in this update were adopted using the optional transition method, effective January 1, 2019. The lease commitments appear on our condensed consolidated balance sheets as operating lease right-of-use assets and current and long-term operating lease liabilities. Such amounts are based on the present value of such commitments using our incremental borrowing rate. We have utilized the transition package of practical expedients permitted within the new standard, which allows us to carry forward the historical lease classification. See "Note 5 – Leases" for additional information.

Note 2 - Fair Value Measurement

The following table summarizes the Company's investments at September 30, 2019 and December 31, 2018 measured at fair value on a recurring basis (in thousands):

| | September 30, 2019 | | | December 31, 2018 | | |
|--|--------------------|--|-------------------|-------------------|--|-------------------|
| | Cost | Gross Unrealized Gains (Losses) | Recorded Basis | Cost | Gross Unrealized Gains (Losses) | Recorded Basis |
| Current: | | | | | | |
| Cash equivalents: | | | | | | |
| Money market funds | \$ 6,121 | \$ — | \$ 6,121 | \$ 30 | \$ — | \$ 30 |
| Total cash equivalents | <u>6,121</u> | <u>—</u> | <u>6,121</u> | <u>30</u> | <u>—</u> | <u>30</u> |
| Investments: | | | | | | |
| Corporate bonds | 70,922 | 36 | 70,958 | 20 | — | 20 |
| U.S. treasuries | 18,642 | (27) | 18,615 | 347 | — | 347 |
| U.S. government agency securities | 8,910 | 313 | 9,223 | 50 | (1) | 49 |
| Mortgage backed securities | 2,943 | (8) | 2,935 | — | — | — |
| Asset backed securities | 17 | — | 17 | — | — | — |
| Total current investments | <u>101,434</u> | <u>314</u> | <u>101,748</u> | <u>417</u> | <u>(1)</u> | <u>416</u> |
| Long term: | | | | | | |
| Investments: | | | | | | |
| U.S. treasuries | — | — | — | 794 | (3) | 791 |
| Mortgage backed securities | — | — | — | 484 | (13) | 471 |
| Corporate bonds | — | — | — | 422 | (7) | 415 |
| Asset backed securities | — | — | — | 10 | — | 10 |
| Total long term investments | <u>—</u> | <u>—</u> | <u>—</u> | <u>1,710</u> | <u>(23)</u> | <u>1,687</u> |
| Restricted cash and investments (1): | | | | | | |
| Corporate bonds | 101,533 | 1,793 | 103,326 | 185,116 | (3,739) | 181,377 |
| Mortgage backed securities | 66,012 | 507 | 66,519 | 89,426 | (2,026) | 87,400 |
| U.S. government agency securities | 29,780 | 947 | 30,727 | 45,548 | (908) | 44,640 |
| Money market funds | 19,085 | (2) | 19,083 | 419 | — | 419 |
| U.S. treasuries | 18,397 | 24 | 18,421 | 44,304 | (283) | 44,021 |
| Supranational bonds | 4,769 | 33 | 4,802 | 4,765 | (24) | 4,741 |
| Mutual funds | 2,844 | — | 2,844 | 1,093 | — | 1,093 |
| Asset backed securities | 116 | 1 | 117 | 75 | (1) | 74 |
| Municipal bonds | 50 | — | 50 | 50 | — | 50 |
| Total restricted cash and investments | <u>242,586</u> | <u>3,303</u> | <u>245,889</u> | <u>370,796</u> | <u>(6,981)</u> | <u>363,815</u> |
| Total investments | <u>\$ 350,141</u> | <u>\$ 3,617</u> | <u>\$ 353,758</u> | <u>\$ 372,953</u> | <u>\$ (7,005)</u> | <u>\$ 365,948</u> |

(1) Included in restricted cash and investments within the condensed consolidated balance sheet is restricted cash of \$173.7 million and \$104.5 million as of September 30, 2019 and December 31, 2018, respectively, which is excluded from the table above. Restricted cash and investments are classified as current and noncurrent on the balance sheet based on the nature of the restriction.

The following table summarizes the Company's investments at September 30, 2019 and December 31, 2018 measured at fair value on a recurring basis by fair value hierarchy level (in thousands):

| | September 30, 2019 | | | | December 31, 2018 | | | |
|---|----------------------|-----------------|-------------------|------------------|----------------------|-----------------|-------------------|---------------|
| | Total Recorded Basis | Level 1 | Level 2 | Other (1) | Total Recorded Basis | Level 1 | Level 2 | Other (1) |
| Cash equivalents: | | | | | | | | |
| Money market funds | \$ 6,121 | \$ — | \$ — | \$ 6,121 | \$ 30 | \$ — | \$ — | \$ 30 |
| Investments: | | | | | | | | |
| Corporate bonds | 70,958 | — | 70,958 | — | 435 | — | 435 | — |
| U.S. treasuries | 18,615 | — | 18,615 | — | 1,138 | — | 1,138 | — |
| U.S. government agency securities | 9,223 | — | 9,223 | — | 49 | — | 49 | — |
| Mortgage backed securities | 2,935 | — | 2,935 | — | 471 | — | 471 | — |
| Asset backed securities | 17 | — | 17 | — | 10 | — | 10 | — |
| Restricted cash and investments: | | | | | | | | |
| Corporate bonds | 103,326 | — | 103,326 | — | 181,377 | — | 181,377 | — |
| Mortgage backed securities | 66,519 | — | 66,519 | — | 87,400 | — | 87,400 | — |
| U.S. government agency securities | 30,727 | — | 30,727 | — | 44,640 | — | 44,640 | — |
| Money market funds | 19,083 | — | — | 19,083 | 419 | — | — | 419 |
| U.S. treasuries | 18,421 | — | 18,421 | — | 44,021 | — | 44,021 | — |
| Supranational bonds | 4,802 | — | 4,802 | — | 4,741 | — | 4,741 | — |
| Mutual funds | 2,844 | 2,844 | — | — | 1,093 | 1,093 | — | — |
| Asset backed securities | 117 | — | 117 | — | 74 | — | 74 | — |
| Municipal bonds | 50 | — | 50 | — | 50 | — | 50 | — |
| Total investments | \$ 353,758 | \$ 2,844 | \$ 325,710 | \$ 25,204 | \$ 365,948 | \$ 1,093 | \$ 364,406 | \$ 449 |

(1) Investments in money market funds measured at fair value using the net asset value per share practical expedient are not subject to hierarchy level classification disclosure. The Company invests in money market funds that seek to maintain a stable net asset value. These investments include commingled funds that comprise high-quality short-term securities representing liquid debt and monetary instruments where the redemption value is likely to be the fair value. Redemption is permitted daily without written notice.

The following table summarizes the contractual maturities of the Company's available for sale securities at September 30, 2019. Actual maturities may differ from contractual maturities because borrowers may have the right to prepay obligations with or without prepayment penalties.

| (In thousands) | September 30, 2019 | | | | Total |
|-----------------------------------|--------------------|----------------------|-----------------------|----------------|-------------------|
| | Less than 1 Year | Between 1 to 5 Years | Between 5 to 10 Years | After 10 Years | |
| Corporate bonds | \$ 30,040 | \$ 122,786 | \$ 21,458 | \$ — | \$ 174,284 |
| U.S. government agency securities | 5,499 | 6,443 | 28,008 | — | \$ 39,950 |
| U.S. treasuries | 36,232 | 804 | — | — | \$ 37,036 |
| Money market funds | 25,204 | — | — | — | \$ 25,204 |
| Supranational bonds | — | 4,802 | — | — | \$ 4,802 |
| Asset backed securities | — | 134 | — | — | \$ 134 |
| Municipal bonds | 50 | — | — | — | \$ 50 |
| Total | <u>\$ 97,025</u> | <u>\$ 134,969</u> | <u>\$ 49,466</u> | <u>\$ -</u> | <u>\$ 281,460</u> |

The average contractual maturity of mortgage backed securities was 17 years as of September 30, 2019.

Note 3 – Workers' Compensation Claims

The following table summarizes the aggregate workers' compensation reserve activity (in thousands):

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|--|-------------------------------------|---------------|------------------------------------|----------------|
| | 2019 | 2018 | 2019 | 2018 |
| Beginning balance | | | | |
| Workers' compensation claims liabilities | \$ 430,736 | \$ 390,814 | \$ 413,397 | \$ 363,517 |
| Add: claims expense accrual | | | | |
| Current period | 37,404 | 37,784 | 118,934 | 116,803 |
| Prior periods | (5,593) | (2,327) | (10,245) | (2,333) |
| | <u>31,811</u> | <u>35,457</u> | <u>108,689</u> | <u>114,470</u> |
| Less: claim payments related to | | | | |
| Current period | 8,609 | 7,502 | 14,213 | 13,783 |
| Prior periods | 23,815 | 19,905 | 77,619 | 65,296 |
| | <u>32,424</u> | <u>27,407</u> | <u>91,832</u> | <u>79,079</u> |
| Change in claims incurred in excess of retention limits | (77) | (26) | (208) | (70) |
| Ending balance | | | | |
| Workers' compensation claims liabilities | \$ 430,046 | \$ 398,838 | \$ 430,046 | \$ 398,838 |
| Incurred but not reported (IBNR) | \$ 274,344 | \$ 246,174 | \$ 274,344 | \$ 246,174 |
| Ratio of IBNR to workers' compensation claims liabilities | 64% | 62% | 64% | 62% |

The Company is a self-insured employer with respect to workers' compensation coverage for all of its employees (including employees co-employed through our client service agreements) working in Colorado, Maryland and Oregon. In the state of Washington, state law allows only the Company's staffing services and internal management employees to be covered under the Company's self-insured workers' compensation program. The Company also operates a wholly owned, fully licensed insurance company, Ecole, which provides workers' compensation coverage to the Company's employees working in Arizona and Utah.

For all other clients, the Company obtains policies from Chubb Limited ("Chubb") through an arrangement known as a fronted program, which provides the Company a licensed, admitted insurance carrier to issue policies on behalf of the Company. Chubb assumes credit risk should the Company be unable to satisfy its indemnification obligations.

Through various insurance arrangements, the Company retains risk of loss up to the first \$5.0 million per occurrence, except in Maryland and Colorado, where our retention per occurrence is \$1.0 million and \$2.0 million, respectively.

The fronted program with Chubb requires that collateral be advanced at the inception of the policy term. To partially satisfy these collateral requirements, the Company provided a surety bond of \$15.0 million and a letter of credit of \$63.7 million from its principal bank, Wells Fargo Bank, National Association (the "Bank").

In addition, the Company makes monthly collateral payments into trust accounts (the "Chubb trust accounts") for the fronted program. The balance in the Chubb trust accounts was \$380.6 million and \$451.0 million at September 30, 2019 and December 31, 2018, respectively. The Chubb trust accounts' balances are included as a component of the current and long-term restricted cash and investments on the Company's condensed consolidated balance sheets.

The states of California, Maryland, Oregon, Washington, Colorado and Delaware required us to maintain collateral totaling \$74.8 million and \$85.2 million at September 30, 2019 and December 31, 2018, respectively, to cover potential workers' compensation claims losses related to the Company's current and former status as a self-insured employer. At September 30, 2019, the Company provided surety bonds and standby letters of credit totaling \$74.8 million, including a California requirement of \$55.6 million.

The Company provided a total of \$ 430.0 million and \$413.4 million at September 30, 2019 and December 31, 2018, respectively, as an estimated future liability for unsettled workers' compensation claims liabilities. Of this amount, \$3.0 million and \$3.2 million at September 30, 2019 and December 31, 2018, respectively, represent case reserves incurred in excess of the Company's retention. The accrual for costs incurred in excess of retention limits is offset by a receivable from excess insurance carriers of \$3.0 million and \$3.2 million at September 30, 2019 and December 31, 2018, respectively, included in other assets on the condensed consolidated balance sheets.

Note 4 - Revolving Credit Facility and Long-Term Debt

On August 6, 2019, the Company entered into an amended credit agreement (the "Agreement") with the Bank, which supersedes the previous agreement. The Agreement increased the revolving credit line from \$28.0 million to \$33.0 million and increased the sublimit for standby letters of credit from \$7.5 million to \$8.0 million. At September 30, 2019, \$5.8 million of the sublimit for standby letters of credit was used. The Agreement expires on July 1, 2022.

Advances under the revolving credit line bear interest, as selected by the Company, of (a) the daily floating rate of one month LIBOR plus 1.75% or (b) the fixed rate of LIBOR plus 1.75%. The Agreement also provides for an unused commitment fee of 0.375% per year on the average daily unused amount of the revolving credit line, as well as a fee of 1.75% of the face amount of each letter of credit reserved under the line of credit. The Company had no outstanding borrowings on its revolving credit line at September 30, 2019 and December 31, 2018. The credit facility is collateralized by the Company's accounts receivable and other rights to receive payment.

The Agreement also provides for a \$63.7 million standby letter of credit (the "Chubb Letter of Credit"). The Chubb Letter of Credit has an expiration date of July 1, 2020, subject to automatic renewal in specified circumstances.

In connection with the Chubb Letter of Credit, the Bank has been granted a security interest of first priority in certain blocked securities accounts (collectively, the "Collateral Accounts"). The Company has agreed to deposit in the Collateral Accounts 50% of the Company's consolidated net income (after tax and less cash dividends) for each quarter plus, to the extent necessary, an additional amount by May 15 each year so that the deposits in the Collateral Accounts for the prior year total at least \$16 million. Through the third quarter of 2019, the Company has deposited \$18.1 million into the Collateral Accounts.

The initial fee paid under the Chubb Letter of Credit in June 2018 was equal to 2.5% of the face amount thereof. Upon annual renewal, the fees payable to the Bank quarterly in advance include (a) a fee at the annual rate of 2.5%, calculated based on the difference between the face amount of the Chubb Letter of Credit and 95% of the aggregate value of the Collateral Accounts as of the end of the previous quarter, (b) a fee at the annual rate of 1.0% calculated based on the balance of the face amount, and (c) other fees upon the payment or negotiation of each drawing under the Chubb Letter of Credit.

The Agreement requires the satisfaction of certain financial covenants as follows:

- EBITDA [net income before taxes plus interest expense (net of capitalized interest expense), depreciation expense, and amortization expense] on a rolling four-quarter basis of not less than \$30 million at the end of each fiscal quarter; and
- ratio of restricted and unrestricted cash and investments to workers' compensation and safety incentive liabilities of at least 1.0:1.0, measured quarterly.

The Agreement includes certain additional restrictions as follows:

- incurring additional indebtedness is prohibited without the prior approval of the Bank, other than purchase financing (including capital leases) for the acquisition of assets, provided that the aggregate of all purchase financing does not exceed \$1,000,000 at any time; and
- the Company may not terminate or cancel any of the AICE policies without the Bank's prior written consent.

The Agreement also contains customary events of default and specified cross-defaults under the Company's workers' compensation insurance arrangements. If an event of default under the Agreement occurs and is continuing, the Bank may declare any outstanding obligations under the Agreement to be immediately due and payable. At September 30, 2019, the Company was in compliance with all covenants.

The Company maintains a mortgage loan with the Bank with a balance of approximately \$4.0 million and \$4.2 million at September 30, 2019 and December 31, 2018, respectively, secured by the Company's corporate office building in Vancouver, Washington. This loan requires payment of monthly installments of \$18,375, bearing interest at the one month LIBOR plus 2.0%, with the unpaid principal balance due July 1, 2022.

Note 5 – Leases

Effective January 1, 2019, the Company adopted Accounting Standards Codification (“ASC”) Topic 842 “Leases” using the optional transition method. Under this method of adoption, the prior period comparative information in the consolidated financial statements has not been revised and continues to be reported under the previously applicable lease accounting guidance. Additionally, we elected the package of practical expedients permitted under the transition guidance, which included the carry-forward of historical lease classification.

The Company primarily leases office buildings under operating leases which are included in Operating lease right-of-use (“ROU”) assets, Current operating lease liabilities, and Long-term operating lease liabilities on the condensed consolidated balance sheets. The Company’s leases have remaining terms of 1 to 7 years and often include one or more options to renew. The Company evaluates renewal options at lease inception and on an ongoing basis and includes renewal options that it is reasonably certain to exercise in its expected lease terms when classifying leases and measuring liabilities. Leases with initial terms of 12 months or less are considered short-term lease costs and are not recorded as ROU assets on the condensed consolidated balance sheets. The Company has elected the practical expedient not to separate non-lease components from lease components for all classes of assets. Our lease agreements contain \$3.7 million of residual value guarantees and generally do not contain material variable lease payments or restrictive covenants.

Information related to the Company’s total lease costs were as follows (in thousands):

| | Three Months Ended September 30, 2019 | Nine Months Ended September 30, 2019 |
|-----------------------|--|---|
| Operating lease cost | \$ 2,438 | \$ 6,040 |
| Variable lease cost | 500 | 750 |
| Short-term lease cost | 198 | 442 |
| Total lease cost | <u>\$ 3,136</u> | <u>\$ 7,232</u> |

Information related to the Company’s ROU assets and related lease liabilities were as follows (in thousands):

| | Three Months Ended September 30, 2019 | Nine Months Ended September 30, 2019 |
|---|--|---|
| Cash paid for operating lease liabilities | \$ 1,916 | \$ 5,561 |
| Right-of-use assets obtained in exchange for new operating lease obligations(1) | 513 | 29,028 |

(1) Nine-months ended balance includes \$25.8 million for operating leases existing on January 1, 2019 and \$3.2million for operating leases that commenced in the first nine months of 2019.

| | As of September 30, 2019 |
|---------------------------------------|--------------------------|
| Weighted-average remaining lease term | 4.0 years |
| Weighted-average discount rate | 4.4 % |

The table below reconciles the undiscounted future minimum lease payments (displayed by year and in the aggregate) under noncancellable operating leases with terms of more than one year to the total operating lease liabilities recognized on the condensed consolidated balance sheets as of September 30, 2019 (in thousands):

| | | |
|---|----|---------------|
| October 1, 2019 through December 31, 2019 | \$ | 1,910 |
| 2020 | | 7,227 |
| 2021 | | 6,606 |
| 2022 | | 5,089 |
| 2023 | | 3,720 |
| Thereafter | | 2,116 |
| Total undiscounted future minimum lease payments | | <u>26,668</u> |
| Less: Difference between undiscounted lease payments and discounted operating lease liabilities | | 2,314 |
| Total operating lease liabilities | \$ | <u>24,354</u> |
| Current operating lease liabilities | \$ | 6,448 |
| Long-term operating lease liabilities | | 17,906 |
| Total operating lease liabilities | \$ | <u>24,354</u> |

As previously disclosed in our 2018 Annual Report on Form 10-K, under the previous lease accounting standard, future minimum lease payments for operating leases having initial or remaining noncancellable lease terms in excess of one year would have been as follows (in thousands):

| Year Ending December 31, | | |
|-----------------------------|----|---------------|
| 2019 | \$ | 7,135 |
| 2020 | | 6,198 |
| 2021 | | 5,673 |
| 2022 | | 4,125 |
| 2023 | | 2,642 |
| Thereafter | | 1,474 |
| | \$ | <u>27,247</u> |

Note 6 – Income Taxes

The Company's realization of a portion of net deferred tax assets is based in part on our estimates of the timing of reversals of certain temporary differences and on the generation of taxable income before such reversals.

Under ASC 740, "Income Taxes," management evaluates the realizability of the deferred tax assets on a quarterly basis under a "more-likely than not" standard. As part of this evaluation, management reviews all evidence both positive and negative to determine if a valuation allowance is needed. One component of this analysis is to determine whether the Company was in a cumulative loss position for the most recent 12 quarters. The Company was in a cumulative income position for the 12 quarters ended September 30, 2019.

The Company is subject to income taxes in U.S. federal and multiple state and local tax jurisdictions. The Internal Revenue Service is examining the Company's federal tax returns for the years ended December 31, 2011, 2012, 2013 and 2014. In the major jurisdictions where it operates, the Company is generally no longer subject to income tax examinations by tax authorities for years before 2011.

A portion of the consolidated income the Company generates is not subject to state income tax. Depending on the percentage of this income as compared to total consolidated income, the Company's state effective rate could fluctuate from expectations.

Note 7 – Litigation

On November 21, 2012, David Kaanaana ("Kaanaana"), a former staffing employee, filed a California wage and hour violations lawsuit against BBSI. On May 19, 2016, the court entered a ruling in favor of BBSI, which was subsequently appealed by the plaintiffs. On November 30, 2018, the California Court of Appeal for the Second Appellate District returned its decision in *Kaanaana v. Barrett Business Services, Inc.*, overruling the trial court's decision to dismiss plaintiffs' claims and holding that prevailing wage requirements applicable to "public works" apply to certain types of districts. On January 9, 2019, BBSI filed a petition of review to the California Supreme Court. An amicus letter in support of the petition was filed by the Sanitation Districts of Los Angeles County, joined in by numerous other "special districts" in California. On February 27, 2019, the California Supreme Court granted the petition to review the appellate court's decision.

BBSI is subject to other legal proceedings and claims that arise in the ordinary course of our business. Given the uncertainties surrounding litigation, management is unable to estimate a potential range of loss arising from these actions.

Note 8 – Subsequent Events

We have evaluated events and transactions occurring after the balance sheet date through our filing date and noted no events that are subject to recognition or disclosure.

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

General

Company Background. Barrett Business Services, Inc. ("BBSI," the "Company," "our" or "we"), is a leading provider of business management solutions for small and mid-sized companies. The Company has developed a management platform that integrates a knowledge-based approach from the management consulting industry with tools from the human resource outsourcing industry. This platform, through the effective leveraging of human capital, helps our business owner clients run their businesses more effectively. We believe this platform, delivered through a decentralized organizational structure, differentiates BBSI from our competitors. BBSI was incorporated in Maryland in 1965.

Business Strategy. Our strategy is to align local operations teams with the mission of small and mid-sized business owners, driving value to their business. To do so, BBSI:

- partners with business owners to leverage their investment in human capital through a high-touch, results-oriented approach;
- brings predictability to each client organization through a three-tiered management platform; and
- enables business owners to focus on their core business by reducing organizational complexity and maximizing productivity.

Business Organization. We operate a decentralized delivery model using operationally-focused business teams, typically located within 50 miles of our client companies. These teams are led by senior level business generalists and comprise senior level professionals with expertise in human resources, organizational development, risk mitigation and workplace safety and various types of administration, including payroll. These teams are responsible for growth of their operations, and for providing strategic leadership, guidance and expert consultation to our client companies. The decentralized structure fosters autonomous decision-making in which business teams deliver plans that closely align with the objectives of each business owner client. This structure also provides a means of incubating talent to support increased growth and capacity. We support clients with employees located in 23 states and the District of Columbia through a network of 64 branch locations in California, Oregon, Utah, Washington, Colorado, Idaho, Arizona, Maryland, Nevada, North Carolina, Pennsylvania, Delaware and Virginia. We also have several smaller recruiting locations in our general market areas, which are under the direction of a branch office.

BBSI believes that making significant investments in the best talent available allows us to leverage the value of this investment many times over. We motivate our management employees through a compensation package that includes a competitive base salary and the opportunity for profit sharing. At the branch level, profit sharing is in direct correlation to client performance, reinforcing a culture focused on achievement of client goals.

Services Overview. BBSI's core purpose is to advocate for business owners, particularly in the small and mid-sized business segment. Our evolution from an entrepreneurially run company to a professionally managed organization has helped to form our view that all businesses experience inflection points at key stages of growth. The insights gained through our own growth, along with the trends we see in working with more than 6,400 companies each day, define our approach to guiding business owners through the challenges associated with being an employer. BBSI's business teams align with each business owner client through a structured three-tiered progression. In doing so, business teams focus on the objectives of each business owner and deliver planning, guidance and resources in support of those objectives.

Tier 1: Tactical Alignment

The first stage focuses on the mutual setting of expectations and is essential to a successful client relationship. It begins with a process of assessment and discovery in which the business owner's business objectives, attitudes, and culture are aligned with BBSI's processes, controls and culture. This stage includes an implementation process, which addresses the administrative components of employment.

Tier 2: Dynamic Relationship

The second stage of the relationship emphasizes organizational development as a means of achieving each client's business objectives. There is a focus on process improvement, development of best practices, supervisor training and leadership development.

Tier 3: Strategic Counsel

With an emphasis on advocacy on behalf of the business owner, the third stage of the relationship is more strategic and forward-looking with a goal of cultivating an environment in which all efforts are directed by the mission and long-term objectives of the business owner.

In addition to serving as a resource and guide, BBSI has the ability to provide workers' compensation coverage as a means of meeting statutory requirements and protecting our clients from employment-related injury claims. Through our third-party administrators, we provide claims management services for our clients. We work aggressively to manage and reduce job injury claims, identify fraudulent claims and structure optimal work programs, including modified duty.

Results of Operations

The following table sets forth the percentages of total revenues represented by selected items in the Company's condensed consolidated statements of operations for the three and nine months ended September 30, 2019 and 2018 (\$ in thousands):

| | Percentage of Total Net Revenues | | | | | | | |
|--|----------------------------------|---------------|------------------|--------------|-------------------|--------------|------------------|--------------|
| | Three Months Ended | | | | Nine Months Ended | | | |
| | September 30, | | September 30, | | September 30, | | September 30, | |
| | 2019 | 2018 | 2019 | 2018 | 2019 | 2018 | 2019 | 2018 |
| Revenues: | | | | | | | | |
| Professional employer service fees | \$ 214,156 | 86.4 % | \$ 206,320 | 83.4 % | \$ 607,840 | 87.2 % | \$ 592,559 | 84.3 % |
| Staffing services | 33,806 | 13.6 | 40,967 | 16.6 | 89,319 | 12.8 | 110,307 | 15.7 |
| Total revenues | <u>247,962</u> | <u>100.0</u> | <u>247,287</u> | <u>100.0</u> | <u>697,159</u> | <u>100.0</u> | <u>702,866</u> | <u>100.0</u> |
| Cost of revenues: | | | | | | | | |
| Direct payroll costs | 25,464 | 10.3 | 30,842 | 12.5 | 67,298 | 9.7 | 83,265 | 11.9 |
| Payroll taxes and benefits | 104,847 | 42.3 | 100,348 | 40.6 | 321,341 | 46.1 | 322,784 | 45.9 |
| Workers' compensation | 46,887 | 18.9 | 56,412 | 22.8 | 154,290 | 22.1 | 172,388 | 24.5 |
| Total cost of revenues | <u>177,198</u> | <u>71.5</u> | <u>187,602</u> | <u>75.9</u> | <u>542,929</u> | <u>77.9</u> | <u>578,437</u> | <u>82.4</u> |
| Gross margin | 70,764 | 28.5 | 59,685 | 24.1 | 154,230 | 22.1 | 124,429 | 17.6 |
| Selling, general and administrative expenses | 41,352 | 16.7 | 36,670 | 14.8 | 113,517 | 16.3 | 101,713 | 14.5 |
| Depreciation and amortization | 970 | 0.4 | 949 | 0.4 | 2,909 | 0.4 | 3,228 | 0.5 |
| Income from operations | 28,442 | 11.4 | 22,066 | 8.9 | 37,804 | 5.4 | 19,488 | 2.6 |
| Other income, net | 2,488 | 1.0 | 1,780 | 0.7 | 7,946 | 1.1 | 5,896 | 0.8 |
| Income before income taxes | 30,930 | 12.4 | 23,846 | 9.6 | 45,750 | 6.5 | 25,384 | 3.5 |
| Provision for income taxes | 5,959 | 2.4 | 4,759 | 1.9 | 9,172 | 1.3 | 4,178 | 0.6 |
| Net income | <u>\$ 24,971</u> | <u>10.0 %</u> | <u>\$ 19,087</u> | <u>7.7 %</u> | <u>\$ 36,578</u> | <u>5.2 %</u> | <u>\$ 21,206</u> | <u>2.9 %</u> |

We report PEO revenues net of direct payroll costs because we are not the primary obligor for wage payments to our clients' employees. However, management believes that gross billing amounts and wages are useful in understanding the volume of our business activity and serve as an important performance metric in managing our operations, including the preparation of internal operating forecasts and establishing executive compensation performance goals. We therefore present for purposes of analysis gross billing and wage information for the three and nine months ended September 30, 2019 and 2018.

| (in thousands) | (Unaudited) | | (Unaudited) | |
|------------------------|--------------------|--------------|-------------------|--------------|
| | Three Months Ended | | Nine Months Ended | |
| | September 30, | | September 30, | |
| | 2019 | 2018 | 2019 | 2018 |
| Gross billings | \$ 1,552,882 | \$ 1,447,852 | \$ 4,377,089 | \$ 4,147,179 |
| PEO and staffing wages | \$ 1,322,469 | \$ 1,222,617 | \$ 3,725,416 | \$ 3,503,184 |

Because safety incentives represent consideration payable to PEO customers, safety incentive costs are netted against PEO revenue in our consolidated statements of operations. Management considers safety incentives to be an integral part of our workers' compensation program because they encourage client companies to maintain safe-work practices and minimize workplace injuries. We therefore present below for purposes of analysis non-GAAP gross workers' compensation expense, which represents workers' compensation costs including safety incentive costs. We believe this non-GAAP measure is useful in evaluating the total costs of our workers' compensation program.

| (in thousands) | (Unaudited) Three Months Ended September 30, | | (Unaudited) Nine Months Ended September 30, | |
|--------------------------------------|--|------------------|---|-------------------|
| | 2019 | 2018 | 2019 | 2018 |
| | Workers' compensation | \$ 46,887 | \$ 56,412 | \$ 154,290 |
| Safety incentive costs | 8,265 | 8,790 | 22,801 | 24,394 |
| Non-GAAP gross workers' compensation | <u>\$ 55,152</u> | <u>\$ 65,202</u> | <u>\$ 177,091</u> | <u>\$ 196,782</u> |

In monitoring and evaluating the performance of our operations, management also reviews the following ratios, which represent selected amounts as a percentage of gross billings. Management believes these ratios are useful in understanding the efficiency and profitability of our service offerings.

| | (Unaudited) Percentage of Gross Billings Three Months Ended September 30, | | (Unaudited) Percentage of Gross Billings Nine Months Ended September 30, | |
|--------------------------------------|--|-------|---|-------|
| | 2019 | 2018 | 2019 | 2018 |
| | PEO and staffing wages | 85.2% | 84.4% | 85.1% |
| Payroll taxes and benefits | 6.8% | 6.9% | 7.3% | 7.8% |
| Non-GAAP gross workers' compensation | 3.6% | 4.5% | 4.0% | 4.7% |

The presentation of revenues on a net basis and the relative contributions of staffing and professional employer services revenues can create volatility in our gross margin percentage. A relative increase in professional employer services revenue will result in a higher gross margin percentage. Improvement in gross margin percentage occurs because incremental client services revenue dollars are reported as revenue net of all related direct payroll and safety incentive costs.

Three Months Ended September 30, 2019 and 2018

Net income for the third quarter of 2019 amounted to \$25.0 million compared to net income of \$19.1 million for the third quarter of 2018. Diluted income per share for the third quarter of 2019 was \$3.24 compared to diluted income per share of \$2.50 for the third quarter of 2018.

Revenues for the third quarter of 2019 totaled \$248.0 million, an increase of \$0.7 million or 0.3% over the third quarter of 2018, which reflects an increase in the Company's professional employer service fee revenue of \$7.8 million or 3.8% and a decrease in staffing services revenue of \$7.2 million or 17.5%.

Our growth in professional employer service revenues was attributable to both new and existing customers. Due to continued strength in our referral channels, business from new customers during the third quarter of 2019 exceeded business lost from former customers. Gross billings for PEO services to continuing customers increased 5.7% compared to the third quarter of 2018. This growth was primarily the result of wage inflation, increases in employee headcount, and one additional day in the third quarter of 2019 compared to the third quarter of 2018. PEO revenue is presented net of safety incentives of \$8.3 million and \$8.8 million in the third quarter of 2019 and 2018, respectively. The decrease in staffing services revenue was due primarily to tight labor market conditions during the 2019 period.

Gross margin for the third quarter of 2019 totaled \$70.8 million or 28.5% of revenue compared to \$59.7 million or 24.1% of revenue for the third quarter of 2018. The increase in gross margin as a percentage of revenues is primarily due to a decrease in workers' compensation expense as a percentage of revenues.

Direct payroll costs for the third quarter of 2019 totaled \$25.5 million or 10.3% of revenue compared to \$30.8 million or 12.5% of revenue for the third quarter of 2018. The decrease in direct payroll costs percentage was primarily due to the increase in professional employer services and the decrease of staffing services within the mix of our customer base compared to the third quarter of 2018.

Payroll taxes and benefits for the third quarter of 2019 totaled \$104.8 million or 42.3% of revenue compared to \$100.3 million or 40.6% of revenue for the third quarter of 2018. The increase in payroll taxes and benefits as a percentage of revenues is primarily due to the relative increase in PEO services within the mix of our customer base compared to the third quarter of 2018.

Workers' compensation expense for the third quarter of 2019 totaled \$46.9 million or 18.9% of revenue compared to \$56.4 million or 22.8% of revenue for the third quarter of 2018. The decrease in workers' compensation expense as a percentage of revenue was primarily due to lower frictional costs and a favorable adjustment of \$5.6 million related to prior period claims during the quarter.

Selling, general and administrative ("SG&A") expenses for the third quarter of 2019 totaled \$41.4 million or 16.7% of revenue compared to \$36.7 million or 14.8% of revenue for the third quarter of 2018. The increase was primarily attributable to an increase in employee-related expenses.

Other income, net for the third quarter of 2019 was \$2.5 million as compared to other income, net of \$1.8 million for the third quarter of 2018. The change was primarily attributable to an increase in investment income in the third quarter of 2019.

Our effective income tax rate for the third quarter of 2019 was 19.3%, compared to 20.0% for the third quarter of 2018. Our income tax rate typically differs from the federal statutory tax rate of 21% primarily due to state taxes and federal and state tax credits.

Nine Months Ended September 30, 2019 and 2018

Net income for the first nine months of 2019 amounted to \$36.6 million compared to net income of \$21.2 million for the first nine months of 2018. Diluted income per share for the first nine months of 2019 was \$4.76 compared to diluted income per share of \$2.77 for the first nine months of 2018.

Revenues for the first nine months of 2019 totaled \$697.2 million, a decrease of \$5.7 million or 0.8% over the first nine months of 2018, which reflects an increase in the Company's professional employer service fee revenue of \$15.3 million or 2.6% and a decrease in staffing services revenue of \$21.0 million or 19.0%.

Our growth in professional employer service revenues was attributable to both new and existing customers. Due to continued strength in our referral channels, business from new customers during the first nine months of 2019 exceeded business lost from former customers. Gross billings for PEO services to continuing customers increased 3.7% compared to the first nine months of 2018. This growth was primarily the result of wage inflation and increases in employee headcount. PEO revenue is presented net of safety incentives of \$22.8 million and \$24.4 million in the first nine months of 2019 and 2018, respectively. The decrease in staffing services revenue was due primarily to tight labor market conditions during the 2019 period.

Gross margin for the first nine months of 2019 totaled \$154.2 million or 22.1% of revenue compared to \$124.4 million or 17.6% of revenue for the first nine months of 2018. The increase in gross margin as a percentage of revenues is primarily due to a decrease in workers' compensation expense as a percentage of revenues.

Direct payroll costs for the first nine months of 2019 totaled \$67.3 million or 9.7% of revenue compared to \$83.3 million or 11.9% of revenue for the first nine months of 2018. The decrease in direct payroll percentage was primarily due to the increase in professional employer services and the decrease of staffing services within the mix of our customer base compared to the first nine months of 2018.

Payroll taxes and benefits for the first nine months of 2019 totaled \$321.3 million or 46.1% of revenue compared to \$322.8 million or 45.9% of revenue for the first nine months of 2018. The increase in payroll taxes and benefits as a percentage of revenues is primarily due to the relative increase in PEO services within the mix of our customer base compared to the first nine months of 2018.

Workers' compensation expense for the first nine months of 2019 totaled \$154.3 million or 22.1% of revenue compared to \$ 172.4 million or 24.5% of revenue for the first nine months of 2018. The decrease in workers' compensation expense as a percentage of revenue was primarily due to lower frictional costs and favorable adjustments of \$10.2 million related to prior period claims during the first nine months of 2019.

SG&A expenses for the first nine months of 2019 totaled \$113.5 million or 16.3% of revenue compared to \$101.7 million or 14.5% of revenue for the first nine months of 2018. The increase was primarily attributable to an increase in employee-related expenses.

Other income, net for the first nine months of 2019 was \$7.9 million as compared to other income, net of \$5.9 million for the first nine months of 2018. The change was primarily attributable to an increase in investment income in the first nine months of 2019.

Our effective income tax rate for the first nine months of 2019 was 20.0% compared to 16.5% for the first nine months of 2018. Our income tax rate typically differs from the federal statutory tax rate of 21% primarily due to state taxes and federal and state tax credits.

Fluctuations in Quarterly Operating Results

We have historically experienced significant fluctuations in our quarterly operating results, including losses in the first quarter of each year, and expect such fluctuations to continue in the future. Our operating results may fluctuate due to a number of factors such as seasonality, wage limits on statutory payroll taxes, claims experience for workers' compensation, demand for our services, and competition. Payroll taxes, as a component of cost of revenues, generally decline throughout a calendar year as the applicable statutory wage bases for federal and state unemployment taxes and Social Security taxes are exceeded on a per employee basis. Our revenue levels may be higher in the third quarter due to the effect of increased business activity of our customers' businesses in the agriculture, food processing and forest products-related industries. In addition, revenues in the fourth quarter may be reduced by many customers' practice of operating on holiday-shortened schedules. Workers' compensation expense varies with both the frequency and severity of workplace injury claims reported during a quarter and the estimated future costs of such claims. In addition, adverse loss development of prior period claims during a subsequent quarter may also contribute to the volatility in the Company's estimated workers' compensation expense.

Liquidity and Capital Resources

The Company's cash balance of \$235.5 million, which includes cash, cash equivalents, and restricted cash, increased \$94.8 million for the nine months ended September 30, 2019, compared to a decrease of \$15.1 million for the comparable period of 2018. The increase in cash at September 30, 2019 as compared to December 31, 2018 was primarily due to net income, increased accrued payroll, payroll taxes and related benefits, increased workers' compensation claims liabilities, and proceeds from the sales and maturities of investments and restricted investments.

Net cash provided by operating activities for the nine months ended September 30, 2019 was \$57.5 million, compared to net cash provided of \$46.9 million for the comparable period of 2018. For the nine months ended September 30, 2019, cash flow from operating activities was primarily due to net income of \$36.6 million, increased accrued payroll, payroll taxes and related benefits of \$40.8 million and increased workers' compensation claims liabilities of \$16.9 million, partially offset by increased trade accounts receivable of \$35.9 million and decreased other accrued liabilities of \$7.3 million.

Net cash provided by investing activities for the nine months ended September 30, 2019 was \$46.1 million, compared to net cash used of \$53.7 million for the comparable period of 2018. For the nine months ended September 30, 2019, cash provided by investing activities consisted primarily of proceeds from sales and maturities of investments and restricted investments of \$58.4 million, partially offset by purchases of property and equipment of \$7.7 million and purchases of restricted investments of \$3.9 million.

Net cash used in financing activities for the nine months ended September 30, 2019 was \$8.8 million, compared to net cash used of \$8.3 million for the comparable period of 2018. For the nine months ended September 30, 2019, cash was primarily used for dividend payments of \$6.0 million and common stock repurchased on vesting of restricted stock units of \$3.1 million.

As part of its fronted workers' compensation insurance program with Chubb, the Company makes monthly collateral payments into trust accounts (the "Chubb trust accounts"). The balance in the Chubb trust accounts was \$380.6 million and \$451.0 million at September 30, 2019 and December 31, 2018, respectively. Included within the Chubb trust account at September 30, 2019, is \$172.9 million of restricted cash. The restricted cash accrues interest at the 3-month Treasury bill yield rate plus 0.25%. The Chubb trust accounts balances are included as a component of the current and long-term restricted cash and investments on the Company's condensed consolidated balance sheets.

On August 6, 2019, the Company entered into an amended credit agreement (the "Agreement") with the Bank, which supersedes the previous agreement. The Agreement increased the revolving credit line from \$28.0 million to \$33.0 million and increased the sublimit for standby letters of credit from \$7.5 million to \$8.0 million. At September 30, 2019, \$5.8 million of the sublimit for standby letters of credit was used. The Agreement expires on July 1, 2022.

Advances under the revolving credit line bear interest, as selected by the Company, of (a) the daily floating rate of one month LIBOR plus 1.75% or (b) the fixed rate of LIBOR plus 1.75%. The Agreement also provides for an unused commitment fee of 0.375% per year on the average daily unused amount of the revolving credit line, as well as a fee of 1.75% of the face amount of each letter of credit reserved under the line of credit. The Company had no outstanding borrowings on its revolving credit line at September 30, 2019 and December 31, 2018. The credit facility is collateralized by the Company's accounts receivable and other rights to receive payment.

The Agreement also provides for a \$63.7 million standby letter of credit (the "Chubb Letter of Credit"). The Chubb Letter of Credit has an expiration date of July 1, 2020, subject to automatic renewal in specified circumstances.

In connection with the Chubb Letter of Credit, the Bank has been granted a security interest of first priority in certain blocked securities accounts (collectively, the "Collateral Accounts"). The Company has agreed to deposit in the Collateral Accounts 50% of the Company's consolidated net income (after tax and less cash dividends) for each quarter plus, to the extent necessary, an additional amount by May 15 each year so that the deposits in the Collateral Accounts for the prior year total at least \$16 million. Through the third quarter of 2019, the Company deposited \$18.1 million into the Collateral Accounts.

The initial fee paid under the Chubb Letter of Credit in June 2018 was equal to 2.5% of the face amount thereof. Upon annual renewal, the fees payable to the Bank quarterly in advance include (a) a fee at the annual rate of 2.5%, calculated based on the difference between the face amount of the Chubb Letter of Credit and 95% of the aggregate value of the Collateral Accounts as of the end of the previous quarter, (b) a fee at the annual rate of 1.0% calculated based on the balance of the face amount, and (c) other fees upon the payment or negotiation of each drawing under the Chubb Letter of Credit.

The Agreement requires the satisfaction of certain financial covenants as follows:

- EBITDA [net income before taxes plus interest expense (net of capitalized interest expense), depreciation expense, and amortization expense] on a rolling four-quarter basis of not less than \$30 million at the end of each fiscal quarter; and
- ratio of restricted and unrestricted cash and investments to workers' compensation and safety incentive liabilities of at least 1.0:1.0, measured quarterly.

The Agreement includes certain additional restrictions as follows:

- incurring additional indebtedness is prohibited without the prior approval of the Bank, other than purchase financing (including capital leases) for the acquisition of assets, provided that the aggregate of all purchase financing does not exceed \$1,000,000 at any time; and
- the Company may not terminate or cancel any of the AICE policies without the Bank's prior written consent.

The Agreement also contains customary events of default and specified cross-defaults under the Company's workers' compensation insurance arrangements. If an event of default under the Agreement occurs and is continuing, the Bank may declare any outstanding obligations under the Agreement to be immediately due and payable. At September 30, 2019, the Company was in compliance with all covenants.

The Company maintains a mortgage loan with the Bank with a balance of approximately \$4.0 million and \$4.2 million at September 30, 2019 and December 31, 2018, respectively, secured by the Company's corporate office building in Vancouver, Washington. This loan requires payment of monthly installments of \$18,375, bearing interest at the one month LIBOR plus 2.0%, with the unpaid principal balance due July 1, 2022.

Management expects that the funds anticipated to be generated from operations, current liquid assets, and availability under the Company's revolving credit facility will be sufficient in the aggregate to fund the Company's working capital needs for the next twelve months.

Inflation

Inflation generally has not been a significant factor in the Company's operations during the periods discussed above. The Company has taken into account the impact of escalating medical and other costs in establishing reserves for future workers' compensation claims payments.

Forward-Looking Information

Statements in this report include forward-looking statements which are not historical in nature and are forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. These forward-looking statements include, among others, discussion of economic conditions in our market areas and their effect on revenue levels, the effect of changes in our mix of services on gross margin, the effect of tight labor market conditions, the adequacy of our workers' compensation reserves, the effect of changes in estimates of our future claims liabilities on our workers' compensation reserves, including the effect of changes in our reserving practices and claims management process on our actuarial estimates, expected levels of required surety deposits and letters of credit, the effects of recent federal tax legislation, our ability to generate sufficient taxable income in the future to utilize our deferred tax assets, the effect of our formation and operation of two wholly owned licensed insurance subsidiaries, the risks of operation and cost of our fronted insurance program with Chubb, the financial viability of our excess insurance carriers, the effectiveness of our management information systems, our relationship with our primary bank lender and the availability of financing and working capital to meet our funding requirements, litigation costs, the effect of changes in the interest rate environment on the value of our investment securities and long-term debt, the adequacy of our allowance for doubtful accounts, and the potential for and effect of acquisitions.

All of our forward-looking statements involve known and unknown risks, uncertainties and other factors that may cause the actual results, performance or achievements of the Company or industry to be materially different from any future results, performance or achievements expressed or implied by such forward-looking statements. Such factors with respect to the Company include our ability to retain current clients and attract new clients, difficulties associated with integrating clients into our operations, economic trends in our service areas, the potential for material deviations from expected future workers' compensation claims experience, the workers' compensation regulatory environment in our primary markets, security breaches or failures in the Company's information technology systems, collectability of accounts receivable, changes in effective payroll tax rates and federal and state income tax rates, the carrying values of deferred income tax assets and goodwill (which may be affected by our future operating results), the impact of the Patient Protection and Affordable Care Act, escalating medical costs, and other health care legislative initiatives on our business, the effect of conditions in the global capital markets on our investment portfolio, and the availability of capital, borrowing capacity on our revolving credit facility, or letters of credit necessary to meet state-mandated surety deposit requirements for maintaining our status as a qualified self-insured employer for workers' compensation coverage or our fronted insurance program. Additional risk factors affecting our business are discussed in Item 1A of Part I of our Annual Report on Form 10-K for the year ended December 31, 2018, which was filed with the SEC on March 5, 2019. We disclaim any obligation to publicly announce any revisions to any of the forward-looking statements contained herein to reflect future events or developments.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

The Company's exposure to market risk for changes in interest rates primarily relates to its investment portfolio and its outstanding borrowings on its line of credit and long-term debt. As of September 30, 2019, the Company's investments consisted principally of \$174 million in corporate bonds, \$69 million in mortgage backed securities, \$40 million in U.S. government agency securities, \$37 million in U.S. treasuries, \$25 million in money market funds, \$5 million in supranational bonds, and \$3 million in mutual funds. The Company's outstanding debt totaled approximately \$4.0 million at September 30, 2019. Based on the Company's overall interest exposure at September 30, 2019, a 50 basis point increase in market interest rates would have a \$4.1 million effect on the fair value of the Company's investment portfolio. A 50 basis point increase would have an immaterial effect on the Company's outstanding borrowings because of the relative size of the outstanding borrowings.

Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

Management is responsible for establishing and maintaining adequate internal control over financial reporting ("ICFR") as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act. Our ICFR is a process designed by, or under the supervision of, our Chief Executive Officer ("CEO") and Chief Financial Officer ("CFO"), to provide reasonable assurance regarding the reliability of financial reporting and the preparation of our condensed consolidated financial statements for external purposes in accordance with GAAP.

We maintain "disclosure controls and procedures" that are designed with the objective of providing reasonable assurance that information required to be disclosed in the reports we file or submit under the Securities Exchange Act of 1934, as amended (the "Exchange Act"), is recorded, processed, summarized, and reported within the time periods specified in the SEC's rules and forms, and that such information is accumulated and communicated to our management, including our CEO and CFO, as appropriate, to allow timely decisions regarding required disclosure. In designing and evaluating our disclosure controls and procedures, our management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives, and our management is required to apply their judgment in evaluating the cost-benefit relationship of possible controls and procedures.

Based on their evaluation, the Company's CEO and CFO have concluded that the Company's disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act) were effective as of September 30, 2019.

Changes in Internal Control over Financial Reporting

There have been no changes in the Company's internal control over financial reporting that occurred during the quarter ended September 30, 2019 that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

Inherent Limitations

Control systems, no matter how well designed and operated, can provide only reasonable, not absolute, assurance that the control systems' objectives are being met. Further, the design of any control systems must reflect the fact that there are resource constraints, and the benefits of all controls must be considered relative to their costs. Due to the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within the Company have been detected. These inherent limitations include the realities that judgments in decision making can be faulty and that breakdowns can occur because of simple errors or mistakes. Control systems can also be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the controls. The design of any system of controls is based in part on certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions. Over time, controls may become inadequate because of changes in conditions or deterioration in the degree of compliance with policies or procedures.

PART II-OTHER INFORMATION**Item 1. Legal Proceedings**

See the information disclosed in "Note 7 - Litigation," to the condensed consolidated financial statements included in Part I of this report, which is incorporated herein by reference.

Item 1A. Risk Factors

There have been no material changes in the risk factors included in our Annual Report on Form 10-K for the year ended December 31, 2018, which was filed with the SEC on March 5, 2019.

Item 6.

Exhibits

- 31.1 [Certification of Chief Executive Officer pursuant to Rule 13a-14\(a\).](#)
- 31.2 [Certification of Chief Financial Officer pursuant to Rule 13a-14\(a\).](#)
- 32 [Certification pursuant to 18 U.S.C. Section 1350.](#)
- 101 INS XBRL Instance Document
- 101 SCH XBRL Taxonomy Extension Schema Document
- 101 CAL XBRL Taxonomy Extension Calculation Linkbase Document
- 101 DEF XBRL Taxonomy Extension Definition Linkbase Document
- 101 LAB XBRL Taxonomy Extension Label Linkbase Document
- 101 PRE XBRL Taxonomy Extension Presentation Linkbase Document

** Except as otherwise indicated, the SEC File Number for all exhibits is 000-21886.

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

BARRETT BUSINESS SERVICES, INC.
Registrant

Date: November 6, 2019

By: /s/ Gary E. Kramer
Gary E. Kramer
Vice President-Finance, Treasurer and Secretary

CERTIFICATION OF CHIEF EXECUTIVE OFFICER

I, Michael L. Elich, certify that:

1. I have reviewed this Quarterly Report on Form 10-Q of Barrett Business Services, Inc.;
2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;
3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the Registrant as of, and for, the periods presented in this quarterly report;
4. The Registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the Registrant and have:
 - a. designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the Registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;
 - b. designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - c. evaluated the effectiveness of the Registrant's disclosure controls and procedures and presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report, based on such evaluation; and
 - d. disclosed in this report any change in the Registrant's internal control over financial reporting that occurred during the registrant's most-recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the Registrant's internal control over financial reporting; and
5. The Registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the Registrant's auditors and the audit committee of the Registrant's board of directors (or persons performing the equivalent functions):
 - a. all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the Registrant's ability to record, process, summarize and report financial information; and
 - b. any fraud, whether or not material, that involves management or other employees who have a significant role in the Registrant's internal control over financial reporting.

Date: November 6, 2019

/s/ Michael L. Elich
Michael L. Elich
Chief Executive Officer

CERTIFICATION OF CHIEF FINANCIAL OFFICER

I, Gary E. Kramer, certify that:

1. I have reviewed this Quarterly Report on Form 10-Q of Barrett Business Services, Inc.;
2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;
3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the Registrant as of, and for, the periods presented in this quarterly report;
4. The Registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the Registrant and have:
 - a. designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the Registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;
 - b. designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - c. evaluated the effectiveness of the Registrant's disclosure controls and procedures and presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report, based on such evaluation; and
 - d. disclosed in this report any change in the Registrant's internal control over financial reporting that occurred during the registrant's most-recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the Registrant's internal control over financial reporting; and
5. The Registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the Registrant's auditors and the audit committee of the Registrant's board of directors (or persons performing the equivalent functions):
 - a. all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the Registrant's ability to record, process, summarize and report financial information; and
 - b. any fraud, whether or not material, that involves management or other employees who have a significant role in the Registrant's internal control over financial reporting.

Date: November 6, 2019

/s/ Gary E. Kramer
Gary E. Kramer
Chief Financial Officer

**CERTIFICATION PURSUANT TO
18 U.S.C. SECTION 1350**

In connection with the Quarterly Report of Barrett Business Services, Inc. (the "Company") on Form 10-Q for the period ended September 30, 2019 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), the undersigned certify, pursuant to 18 U.S.C. § 1350, that:

- (1) The Report fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
- (2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

/s/ Michael L. Elich

Michael L. Elich
Chief Executive Officer

November 6, 2019

/s/ Gary E. Kramer

Gary E. Kramer
Chief Financial Officer

November 6, 2019

A signed original of this written statement required by Section 906 has been provided to Barrett Business Services, Inc. and will be retained by Barrett Business Services, Inc. and furnished to the Securities and Exchange Commission or its staff upon request.