

**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-K**

(Mark One)

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

For the Fiscal Year Ended: December 31, 2016

or

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

For the Transition Period from

to

Commission file number 001-34702

SPS COMMERCE, INC.

(Exact Name of Registrant as Specified in its Charter)

Delaware

*(State or Other Jurisdiction of
Incorporation or Organization)*

41-2015127

*(I.R.S. Employer
Identification No.)*

333 South Seventh Street, Suite 1000, Minneapolis, MN 55402

(Address of Principal Executive Offices, Including Zip Code)

(612) 435-9400

(Registrant's Telephone Number, Including Area Code)

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

Common stock, par value \$0.001 per share
(Title of each class)

The Nasdaq Stock Market LLC
(Nasdaq Global Market)
(Name of each exchange on which registered)

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

None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or 15(d) of the Act. Yes No

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§229.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§ 229.405 of this chapter) is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

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

Large Accelerated Filer Accelerated Filer Non-Accelerated Filer Smaller Reporting Company
(Do not check if a smaller reporting company)

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 June 30, 2016, the last business day of the registrant's most recently completed second fiscal quarter, the aggregate market value of shares of the registrant's common stock held by non-affiliates of the registrant (based upon the closing sale price of \$60.60 per share on the Nasdaq Global Market on such date) was approximately \$1.0 billion.

The number of shares of the registrant's common stock, par value \$0.001 per share, outstanding as of February 10, 2017 was 17,180,650 shares.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Company's definitive Proxy Statement for the Annual Meeting of Stockholders to be held on May 23, 2017 (the "2017 Proxy Statement"), which is expected to be filed within 120 days after the end of the fiscal year covered by this Annual Report on Form 10-K, are incorporated by reference in Part III of this Annual Report on Form 10-K.

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SPS COMMERCE, INC.
ANNUAL REPORT ON FORM 10-K

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SPECIAL NOTE REGARDING FORWARD-LOOKING INFORMATION

This Annual Report on Form 10-K contains forward-looking statements regarding us, our business prospects and our results of operations that are subject to certain risks and uncertainties posed by many factors and events that could cause our actual business, prospects and results of operations to differ materially from those that may be anticipated by such forward-looking statements. Factors that could cause or contribute to such differences include, but are not limited to, those described under the heading “*Risk Factors*” included in this Annual Report on Form 10-K. Readers are cautioned not to place undue reliance on these forward-looking statements, which speak only as of the date of this report. In some cases, you can identify forward-looking statements by the following words: “anticipate,” “believe,” “continue,” “could,” “estimate,” “expect,” “intend,” “may,” “ongoing,” “plan,” “potential,” “predict,” “project,” “should,” “will,” “would,” or the negative of these terms or other comparable terminology, although not all forward-looking statements contain these words. We expressly disclaim any intent or obligation to update or revise any forward-looking statements, whether as a result of new information, future events or otherwise. Readers are urged to carefully review and consider the various disclosures made by us in this report and in our other reports filed with the Securities and Exchange Commission that advise interested parties of the risks and factors that may affect our business.

PART I

Item 1. *Business*

Overview

We are a leading provider of cloud-based supply chain management solutions, providing network-proven fulfillment, sourcing, and item assortment management solutions, along with comprehensive retail performance analytics to thousands of customers worldwide. We provide our solutions through the SPS Commerce platform, a cloud-based product suite that improves the way suppliers, retailers, distributors and logistics firms orchestrate the sourcing, set up of new vendors and items, and fulfillment of products that customers buy from retailers and suppliers. Implementing and maintaining this suite of supply chain management capabilities is resource intensive and not a core competency for most businesses. The SPS Commerce platform eliminates the need for on-premise software and support staff, which enables our supplier customers to focus their resources on their core business. The SPS Commerce platform enables retailers, suppliers, and logistics firms to increase supply cycle agility, optimize inventory levels and sell-through, reduce costs, increase visibility into customer orders, and ensure suppliers satisfy exacting retailer requirements.

As of December 31, 2016, we had approximately 25,000 customers with contracts to pay us monthly fees, which we refer to as recurring revenue customers. We have also generated revenues by providing our cloud-based supply chain management solutions to an additional 45,000 organizations that, together with our recurring revenue customers, we refer to as our customers. Once connected to our platform, our customers often require integrations to new organizations that represent an expansion of our platform and new sources of revenues for us.

As a provider of cloud services, we enable our customers to easily interact with their trading partners around the world without the local implementation and servicing of software that traditional on-premise solutions require. Our delivery model also enables us to offer functionality, integration, analytics and reliability with less cost and risk than traditional solutions.

For 2016, 2015, and 2014, we generated revenues of \$193.3 million, \$158.5 million and \$127.9 million, respectively. Our fiscal quarter ended December 31, 2016 represented our 64th consecutive quarter of increased revenues. Recurring revenues from recurring revenue customers accounted for 91.6%, 90.8% and 90.0% of our total revenues for 2016, 2015, and 2014, respectively. Our revenues are not concentrated with any customer, as our largest customer represented 2% or less of total revenues for 2016, 2015, and 2014.

Our Industry

Today's Retail Landscape

One of the driving factors in the retail industry today is the rising influence of e-commerce and the mobile shopping experience. The retail industry is in the midst of a transformation, as retailers, suppliers and the many companies that facilitate transactions in the industry reshape how they do business and adapt to omnichannel retailing — defined as providing a shopper with a consistent experience wherever they might engage a retailer (or increasingly a supplier), whether bricks-and-mortar, website, or mobile experience. E-commerce is changing the selling channels for retailers and suppliers. These changes are requiring retailers, suppliers, and logistics partners to accelerate the speed and volume of sourcing new items to sell; setting up the items to be sold and delivered through multiple channels; and then, analyzing performance to make changes. Once in place, items need to be sold and fulfilled through different channels based on the consumers' need which requires improved adaptability to adjust to that consumer request without friction. New business processes and technology are required to accomplish this.

Supply Chain Management Industry Background

The supply chain management industry enables thousands of retailers around the world to transact and grow their relationships with tens of thousands of suppliers. Additional participants in this market include distributors, third-party logistics providers, manufacturers, fulfillment and warehousing providers and sourcing companies. Supply chain management involves communicating data about the goods themselves, data related to the

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exchange of goods among these trading partners, and information about the many thousands of companies who are members of the supply chain community. At every stage of the supply chain there are inefficient, labor-intensive processes between trading partners with significant documentation requirements, such as the counting, sorting and verifying of goods before shipment, while in transit and upon delivery — and traditional legacy systems offer very limited, if any, real time visibility into progress or status. Modern supply chain management solutions must address trading partners' needs for integration, collaboration, connectivity, visibility and data analytics to improve the agility, accuracy and efficiency with which goods are ordered and supplied.

The industry initially focused on automating and streamlining the processing of fulfilling transactions between retailers and suppliers, and others in the supply chain, ensuring orders were placed accurately and quickly, and that goods were delivered on time and meeting the retailer's requirements. As the pace of change in retailing has accelerated with the convergence of digital and physical commerce, today's supply chain solutions need to provide real time visibility into the status of an order. This requires orchestrating a growing set of valuable capabilities that draw on foundational transaction information, and add value beyond the traditional supply chain management function within retailers and suppliers. In today's rapidly changing omnichannel retail market, where retailers and suppliers are increasingly focused on electronic commerce and brick-and-mortar commerce as a continuum, supply chain information and visibility to it has a role across the entire enterprise. Demand planning and forecasting groups need visibility from the front of the store all the way back to the factory to ensure supply meets demand. Sourcing operations require access to thousands of new items to drive their e-commerce growth and ensure physical stores have the items consumers will find compelling and engaging.

As familiarity and acceptance of cloud-based services continues to accelerate, we believe companies, both large and small, will continue to turn to cloud-based services similar to ours to provide them with the agility and insight their supply chains need in today's retail marketplace. Increasingly, traditional supply chain technologies and on-premise software deployments do not provide the complex orchestration, analytics, and insight required today.

The Omnichannel Foundation — Fulfillment Automation Between Retailers and Suppliers

Retailers impose an increasingly stringent and complex set of specific work-flow rules and standards on their trading partners for electronically orchestrating their fulfillment of orders. These "rule books" include specific business processes for suppliers to exchange data and documentation requirements such as invoices, purchase orders and advance shipping notices. Rule books can be hundreds of pages, and retailers frequently have multiple rule books for international requirements or specific fulfillment models. Suppliers working with multiple retailers need to accommodate different rule books for each retailer. These rule books are not standardized between retailers, but vary based on a retailer's size, industry and technological capabilities. The responsibility for creating information "maps," which are integration connections between the retailer and the supplier that comply with the retailer's rule books, resides primarily with the supplier. The cost of noncompliance can be refusal of delivered goods, fines and ultimately a termination of the supplier's relationship with the retailer. The complexity of retailers' requirements and consequences of noncompliance create growing demand for specialized supply chain management automation solutions.

Traditional Supply Chain Management Solutions

Traditional supply chain management solutions, which range from non-automated paper or fax solutions to electronic solutions, implemented using on-premise licensed software, tend to focus primarily on fulfillment automation. On-premise licensed software provides connectivity between only one organization and its trading partners and typically requires significant time and technical expertise to configure, deploy and maintain. Historically these software providers primarily linked retailers and suppliers through the Electronic Data Interchange (EDI) protocol that enables the structured electronic transmission of data between organizations. Increasingly organizations are utilizing direct communication between systems utilizing application programming interfaces (APIs). Because of set-up and maintenance costs, technical complexity and a growing volume of requirements from retailers, the traditional software model is not well suited for many suppliers, especially those small and medium in size.

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Additionally, the traditional approach to supply chain automation involves a system architecture made up of many point-to-point connections between retailers and their suppliers. These collections of connections are inherently error prone and can be difficult to adapt to changing requirements and market circumstances. For instance, if there is a broad trend in the market (such as the growing popularity of mobile commerce) that many members of a retailing segment would like to adapt to, a supplier would be faced with a series of enhancements, on a one-by-one basis, to the collection of connections they have with their retailers. Traditional approaches do not have the inherent, or architectural, capabilities to enable the exchange of information across the retailer's organization or with their trading partners, or the flexibility and agility to embrace the ongoing change that omnichannel retailing requires.

Moving Beyond Transactions — Insight and Data Analysis Powering Intelligent, Responsive Decision Making

Fulfillment automation is a first step toward addressing the complexities in the supply chain ecosystem, but is only the necessary first step in providing omnichannel retail success. As the number and geographic dispersion of trading partners has grown, and the number of individual orders continue to grow, it has never been more important for retailers and suppliers to have precise, timely insight into demand and supply, by order, item and location in the fulfillment journey. In today's retailing marketplace, where an order can be placed by a consumer with the swipe of a finger, retailers need to make fulfillment decisions in an instant, deciding the most cost efficient location of inventory (which could be a warehouse, a store, or a vendor's warehouse). As a result, trading partners need a solution that effectively consolidates, distills and provides visibility and sell-through information to managers and decision-makers who can use the information to drive efficiency, revenue growth and profitability. The abundance of data produced by these processes, including data for fulfillment, sales and inventory levels, is often inaccessible to trading partners for analysis. The data and related analytics are essential for optimizing the inventory and fulfillment process and will continue to drive demand for supply chain management solutions.

Cloud Services Provide Flexibility, Adaptability and a Key Source of Information Across the Supply Chain

Cloud services are well suited for providing the capabilities that retail supply chain management needs today because they inherently enable rapid provisioning of capabilities and offer robust and reliable integration with retailer and supplier systems to provide data and visibility into the orchestration of complex order fulfillment. Cloud services are able to continue utilizing standard connectivity protocols, such as EDI, but also are able to support the growing use of standard internet protocols that retailers require, such as XML, in addition to enabling API-based integration. These cloud services connect suppliers and retailers more efficiently than traditional on-premise software solutions by leveraging the integrations created for a single supplier across all participating suppliers.

Traditionally the supply chain depended on integration with a retailer or supplier's enterprise resource planning (ERP) system, which is the system of record for the bulk of information related to placing an order. In today's retailing market, many systems working closely together are essential to provide the consumer with the merchandising information they need to make a purchase decision (e.g., ecommerce systems) as well as information required to fulfill the order (e.g., warehouse and transportation systems). Cloud services enable an organization to knit the information required for sourcing and merchandising an item, placing an order for that item, and fulfilling that item — connecting information and systems from across the supply chain ecosystem, enabling increased retailer agility and globalization, and addressing the increased complexity affecting the supply chain. In addition, cloud services can integrate supply chain management applications with organizations' existing enterprise resource planning systems.

Cloud services and API-based service integration provide retailers and suppliers with access to new and powerful capabilities quickly, often integrated with analytics to enable rapid service innovation and responsiveness as the retailing landscape continues to respond to omnichannel advancements.

Our Platform

We operate one of the largest retail trading partner networks through a cloud-based services suite that improves the way suppliers, retailers, distributors and other trading partners manage and fulfill orders, manage sell-through performance and source new items. Approximately 70,000 customers across more than 60 countries have used our platform to improve the performance of their trading relationships. Our platform fundamentally changes how organizations use electronic communication to manage their supply chains by replacing the collection of traditional, custom-built, point-to-point integrations with a network model whereby a single integration to our platform enables an organization to connect seamlessly to the entire SPS Commerce network of trading partners.

From that single connection, a member of our network can make use of the full suite of our solutions, from fulfillment automation, to the analysis and optimization of item sell-through performance, to sourcing new items, new retailing relationships or providers of logistics and other services. This represents a fundamental change to fulfillment automation and enables inherent adaptability and flexibility not possible with traditional supply chain management system architectures.

Our platform is comprised of a set of coupled cloud services that deliver value as stand-alone offerings, but also provide additional value when used collectively. Our fulfillment product combines integrations that comply with numerous rule books for retailers and distributors with whom we and our customers have done business. By maintaining current integrations with retailers, our platform removes the need for suppliers to continually stay up-to-date with the rule book changes required by retailers. Moreover, by utilizing a cloud services model, we eliminate or greatly reduce the burden on suppliers to support and maintain an on-premise software application, thereby reducing ongoing operating costs. As the transaction hub for trading partners, we also are able to provide increased performance visibility and data analytics capabilities for retailers and suppliers across their supply chains, each of which is difficult to gain from traditional, point-to-point integration solutions.

The following solutions are enabled through the SPS Commerce cloud services platform:

- *Trading Partner Fulfillment.* Our Fulfillment solution provides fulfillment automation and replaces or augments an organization's existing trading partner electronic communication infrastructure, enabling suppliers to have visibility into the journey of an order and comply with retailers' rule books and enabling the electronic exchange of information among numerous trading partners through various protocols.
- *Trading Partner Analytics.* Our Analytics solution consists of data analytics applications that enable our customers to improve their visibility across, and analysis of, their supply chains. When focused on point-of-sale data, for example, retailers and suppliers can ensure inventory is located where demand is highest. Retailers improve their visibility into supplier performance and their understanding of product sell-through.
- *Trading Partner Assortment.* Today's retail marketplace requires the management of tens and even hundreds of individual attributes associated with each item a retailer or supplier sells today. This information can include digital images/video, customer facing descriptions and measurements, and warehouse information. Our Assortment product provides robust, extensible management of this information, enabling accurate orders and rapid fulfillment.
- *Trading Partner Sourcing.* Through Retail Universe, our social network for the retail industry, retailers can source providers of new items, suppliers can connect with new retailers, and the broader retailing community can make connections to expand their business networks and grow.
- *Trading Partner Community Development.* Our Community Development solution provides communication programs based on our best practices. These programs enable organizations, from large and small retailers and suppliers to emerging providers of value-added products and services, to establish trading partner relationships with new trading partners to expand their businesses.
- *Other Trading Partner Solutions.* We provide a number of peripheral solutions such as barcode labeling, planogram services and our scan and pack application, which helps trading partners process information to streamline the picking and packaging process.

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Our Customer and Sales Sources

As one of the largest providers of cloud services for supply chain management, the trading partner relationships that we enable among our retailer, supplier and fulfillment customers naturally lead to new customer acquisition opportunities.

“Network Effect”

Once connected to our network, trading partners can exchange electronic supply chain information with each other. Through our platform, we have helped approximately 70,000 customers to improve the performance of their trading partner relationships. The value of our platform increases with the number of trading partners connected to the platform. The addition of each new customer to our platform enables that new customer to communicate with our existing customers and enables our existing customers to do business with the new customer. Additionally, through our Sourcing product, our community now has a social network focused on facilitating connections and business interactions among retailers and suppliers. This “network effect” of adding an additional customer to our platform creates a significant opportunity for existing customers to realize incremental sales by working with our new trading partners and vice versa. As a result of this increased volume of activity amongst our network participants, we earn additional revenues from these participants.

Customer Acquisition Sources

Community Enablement. As retailers and suppliers reshape how they do business in an omnichannel landscape, they need to bring new capabilities and services to their trading partner networks. For instance, a supplier may wish to collaborate with their retailers around point-of-sale analytics data, or a retailer may decide to change the workflow or protocol by which it interacts with its suppliers. In each case, the supplier and retailer may engage us to work with its trading partner base to enable the new capability. Performing these programs on behalf of retailers and suppliers often generates supplier sales leads for us.

Referrals from Our Customers. We also receive sales leads from our customers seeking to communicate electronically with their trading partners. For example, a supplier may refer to us its third-party logistics provider or manufacturer which is not in our network.

Channel Partners. In addition to the customer acquisition sources identified above, we market and sell our solutions through a variety of channel partners including software providers, resellers, system integrators and logistics partners. For example, software partners such as Microsoft, NetSuite, Oracle, SAP, Sage and their business partner communities generate sales for us as part of broader enterprise resource planning, warehouse management system and/or transportation management system sales efforts. Our logistics partners also drive new sales both by providing leads and by embedding our solutions as part of their service offerings.

Our Sales Force

We also sell our solutions through a global sales force which is organized as follows:

- *Retailer Sales.* We employ a team of sales professionals who focus on selling our cloud services suite to retailers and distributors.
- *Supplier Sales.* We employ a team of supplier sales representatives focused on selling our cloud services suite to suppliers.
- *Business Development Efforts.* Our business development organization is tasked with finding new sources of revenue and development of new business opportunities through channel partners and other areas that present opportunity for growth.

Our Growth Strategy

Our objective is to be the leading global provider of supply chain management solutions. Key elements of our strategy include:

- *Further Penetrate Our Current Market.* We believe the global supply chain management market is underpenetrated and, as the retail industry continues to respond to the changing requirements of the omnichannel marketplace, and as the supply chain ecosystem becomes more complex and geographically dispersed, the demand for supply chain management solutions will increase, especially among small- and medium-sized businesses. We intend to continue leveraging our relationships with customers and their trading partners to obtain new sales leads.
- *Increase Revenues from Our Customer Base.* We believe our overall customer satisfaction is strong and will lead our customers to further expand their use of the solutions they have currently purchased as well as purchase additional services to continue improving the performance of their trading partner relationships, generating additional revenues for us. In 2015, we hired a Chief Customer Success Officer to lead our customer success efforts and to increase opportunities to sell additional solutions and services to our existing customers. We also expect to introduce new solutions to sell to our customers. We believe our position as the incumbent supply chain management solution provider to our customers, our integration into our recurring revenue customers' business systems and the modular nature of our platform are conducive to deploying additional solutions with customers.
- *Expand Our Distribution Channels.* We intend to grow our business by expanding our network of sales representatives to gain new customers. We also believe there are valuable opportunities to promote and sell our solutions through collaboration with other providers.
- *Expand Our International Presence.* We believe our presence in Asia Pacific, as well as Europe, represents a significant competitive advantage. We plan to increase our international sales efforts to obtain new supplier and retailer customers around the world. We intend to leverage our current international presence to increase the number of integrations we have with retailers in foreign markets to make our platform more valuable to suppliers based overseas.
- *Enhance and Expand Our Platform.* We intend to further improve and develop the functionality and features of our platform, including, from time to time, developing new solutions and applications.
- *Selectively Pursue Strategic Acquisitions.* The fragmented nature of our market provides opportunity for selective acquisitions. In 2014, we purchased substantially all of the assets of Leadtec Systems Australia Pty Ltd ("Leadtec") and its affiliates, a privately-held provider of cloud-based integration solutions in Australia and New Zealand. This acquisition expanded our base of recurring revenue customers and added suppliers to our network. In 2016, we purchased Toolbox Solutions, Inc., a Canadian based point-of-sale analytics and category management services provider to retailers and consumer packaged goods suppliers in North America. To complement and accelerate our internal growth, we may pursue acquisitions of other supply chain management companies to add customers or additional functionalities. We plan to evaluate potential acquisitions of other supply chain management companies primarily based on the number of customers and revenue the acquisition would provide relative to the purchase price. We also may pursue acquisitions that allow us to expand into regions where we do not have a significant presence or to offer new functionalities we do not currently provide. We plan to evaluate potential acquisitions to expand into new regions or offer additional functionalities primarily based on the anticipated growth the acquisition would provide, the purchase price and our ability to integrate and operate the acquired business.

Technology, Development and Operations

Technology

We were an early provider of cloud services to the retail supply chain management industry, launching the first version of our platform in 1997. We use commercially available hardware and cloud services with a combination of proprietary and commercially available software.

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Our cloud platform treats all customers as logically separate tenants in a common platform. As a result, we spread the cost of delivering our solutions across our customer base. Because we do not manage thousands of distinct applications with their own business logic and database schemes, we believe that we can scale our business faster than traditional software vendors, even those that modified their products to be accessible over the Internet.

Development

Our research and development efforts focus on improving and enhancing our existing solutions, as well as developing new solutions and applications and maintaining our existing solutions. Our multi-tenant platform serves all of our customers, which allows us to maintain relatively low research and development expenses and release more frequently compared to traditional on-premise licensed software solutions that support multiple versions. Our development efforts take place at our U.S. locations in Minnesota and New Jersey, as well as in Toronto, Canada, and Kiev, Ukraine.

Operations

We operate infrastructure in third-party data centers located in Minnesota and New Jersey, United States; Melbourne, Australia; Toronto, Canada; as well as provisioned services in public cloud providers. In all cases, infrastructure and services on which our platform runs are managed by us.

We have internal and third party monitoring software that continually checks our platform and key underlying components for continuous availability and performance, ensuring our platform is available and providing adequate service levels. We have a technology operations team that provides system provisioning, management, maintenance, monitoring and back-up.

We operate a service architecture using industry best practices to insure multiple points of redundancy, high availability and scale as needed. Our databases are replicated between locations with a defined recovery point objective.

Our Customers

As of December 31, 2016, we had approximately 25,000 recurring revenue customers and approximately 70,000 total customers. Our primary source of revenue is from small- to mid-sized suppliers in the consumer packaged goods industry. We also generate revenues from other members of the supply chain ecosystem, including retailers, distributors, third-party logistics providers and other trading partners. Our revenues are not concentrated with any customer, as our largest customer represented 2% or less of total revenues in 2016, 2015 and 2014.

Competition

Vendors in the supply chain management industry offer solutions through three delivery methods: on demand or cloud-based, traditional on-premise software and managed services.

The market for cloud-based supply chain management solutions is fragmented and rapidly evolving. Cloud service vendors compete directly with each other based on the following:

- breadth of pre-built connections to retailers, third-party logistics providers and other trading partners;
- history of establishing and maintaining reliable integration connections with trading partners;
- reputation of the cloud service vendor in the supply chain management industry;
- price;

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- specialization in a customer market segment;
- speed and quality with which the cloud service vendor can integrate its customers to their trading partners;
- functionality of the cloud service solution, such as the ability to integrate the solution with a customer's business systems;
- breadth of complementary supply chain management solutions the cloud service vendor offers; and
- training and customer support services provided during and after a customer's initial integration.

We expect to encounter new and increased competition as this market segment consolidates and matures. Consolidation among cloud service vendors could create a direct competitor that is able to compete with us more effectively than the numerous, smaller vendors currently offering cloud service supply chain management solutions. Increased competition from cloud service vendors could reduce our market share, revenues and operating margins or otherwise adversely affect our business.

Cloud service vendors also compete with traditional on-premise software companies and managed service providers. Traditional on-premise software companies focused on supply chain integration management include IBM-Sterling Commerce and OpenText-GXS. These companies offer a "do-it-yourself" approach in which customers purchase, install and manage specialized software, hardware and value-added networks for their supply chain integration needs. This approach requires customers to invest in staff to operate and maintain the software. Traditional on-premise software companies use a single-tenant approach in which information maps to retailers are built for and used by one supplier, as compared to cloud service solutions that allow multiple customers to share information maps with a retailer.

Managed service providers focused on the supply chain management market include IBM-Sterling Commerce and OpenText-GXS. These companies combine traditional on-premise software, hardware and value-added networks with professional information technology services to manage these resources. Like traditional on-premise software companies, managed service providers use a single-tenant approach.

Customers of traditional on-premise software companies and managed service providers typically make significant upfront investments in the supply chain management solutions these competitors provide, which can decrease the customers' willingness to abandon their investments in favor of a cloud service solution. Cloud service supply chain management solutions also are at a relatively early stage of development compared to traditional on-premise software and managed service providers. Cloud service vendors compete with these better established solutions based on total cost of ownership and flexibility. If suppliers do not perceive the benefits of cloud service solutions, or if suppliers are unwilling to abandon their investments in other supply chain management solutions, our business and growth may suffer. In addition, many traditional on-premise software companies and managed service providers have larger customer bases and may be better capitalized than we are, which may provide them with an advantage in developing, marketing or servicing solutions that compete with ours.

Intellectual Property and Proprietary Content

We rely on a combination of copyright, trademark and trade secret laws as well as confidentiality procedures and contractual provisions to protect our proprietary technology and our brand. We enter into confidentiality and proprietary rights agreements with our employees, consultants and other third parties and control access to software, documentation and other proprietary information. We have registered trademarks and pending trademark applications in the United States of America and certain foreign countries. We do not have any patents, but we have pending patent applications. Our trade secrets consist primarily of the software we have developed for our SPS Commerce platform. Our software is also protected under copyright law, but we do not have any registered copyrights.

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Employees

As of December 31, 2016, we had 1,217 employees. We also employ independent contractors to support our operations. We believe that our continued success will depend on our ability to continue to attract and retain skilled technical and sales personnel. We have never had a work stoppage, and none of our employees are represented by a labor union. We believe our relationship with our employees is good.

Company Information

We were originally incorporated as St. Paul Software, Inc., a Minnesota corporation, on January 28, 1987. On May 30, 2001, we reincorporated in Delaware under our current name, SPS Commerce, Inc. Our principal executive offices are located at 333 South Seventh Street, Suite 1000, Minneapolis, Minnesota 55402, and our telephone number is (612) 435-9400. Our website address is www.spscommerce.com. Information on our website does not constitute part of this Annual Report on Form 10-K or any other report we file or furnish with the Securities and Exchange Commission ("SEC"). We provide free access to various reports that we file with or furnish to the SEC through our website as soon as reasonably practicable after they have been filed or furnished. These reports include, but are not limited to, our Annual Reports on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K and any amendments to these reports. Our SEC reports can be accessed through the investor relations section of our website or through the SEC's website at www.sec.gov. Stockholders may also request copies of these documents from:

SPS Commerce, Inc.
Attention: Investor Relations
333 South Seventh Street
Suite 1000
Minneapolis, MN 55402

Executive Officers

Set forth below are the names, ages and titles of the persons serving as our executive officers.

| <u>Name</u> | <u>Age</u> | <u>Position</u> |
|--------------------|------------|--|
| Archie C. Black | 54 | Chief Executive Officer and President |
| Kimberly K. Nelson | 49 | Executive Vice President and Chief Financial Officer |
| James J. Frome | 52 | Executive Vice President and Chief Operating Officer |

Archie C. Black has served as our President and Chief Executive Officer and a director since 2001. Previously, Mr. Black served as our Senior Vice President and Chief Financial Officer from 1998 to 2001. Prior to joining us, Mr. Black was a Senior Vice President and Chief Financial Officer at Investment Advisors, Inc. in Minneapolis, Minnesota and also spent three years at Price Waterhouse.

Kimberly K. Nelson has served as our Executive Vice President and Chief Financial Officer since November 2007. Prior to joining us, Ms. Nelson served as the Finance Director, Investor Relations for Amazon.com from June 2005 through November 2007, and as the Finance Director, Worldwide Application for Amazon.com's Technology group from April 2003 until June 2005. Ms. Nelson also served as Amazon.com's Finance Director, Financial Planning and Analysis from December 2000 until April 2003.

James J. Frome has served as our Executive Vice President and Chief Operating Officer since August 2012. Previously, Mr. Frome served as our Executive Vice President and Chief Strategy Officer from March 2001 to August 2012 and our Vice President of Marketing from July 2000 to March 2001. Prior to joining us, Mr. Frome served as a Divisional Vice President of Marketing at Sterling Software, Inc. from 1999 to 2000 and as a Senior Product Manager and Director of Product Management at Information Advantage, Inc. from 1993 to 1999.

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Item 1A. Risk Factors

Set forth below and elsewhere in this Annual Report on Form 10-K, and in other documents we file with the Securities and Exchange Commission, are risks and uncertainties that could cause our actual results to differ materially from the results contemplated by the forward-looking statements contained in this Annual Report on Form 10-K and in other written and oral communications from time to time. Our business could be harmed by any of these risks. The trading price of our common stock could decline due to any of these risks. In assessing these risks, you should also refer to the other information contained in this Annual Report on Form 10-K, including our financial statements and related notes.

If we are unable to attract new customers, or sell additional solutions, or if our customers do not increase their use of our solutions, our revenue growth and profitability will be adversely affected.

To increase our revenues and achieve and maintain profitability, we must regularly add new customers, sell additional solutions and our customers must increase their use of the solutions for which they currently subscribe. We intend to grow our business by retaining and attracting talent, developing strategic relationships with resellers, including resellers that incorporate our applications in their offerings, and increasing our marketing activities. If we are unable to hire or retain quality personnel, convert companies that have been referred to us by our existing network into paying customers, ensure the effectiveness of our marketing programs, or if our existing or new customers do not perceive our solutions to be of sufficiently high value and quality, we might not be able to increase sales and our operating results will be adversely affected. If we fail to sell our new solutions to existing or new customers, we will not generate anticipated revenues from these solutions, our operating results will suffer and we might be unable to grow our revenues or maintain profitability.

We do not have long-term contracts with most of our recurring revenue customers, and our success therefore depends on our ability to maintain a high level of customer satisfaction and a strong reputation in the supply chain management industry.

Our contracts with our recurring revenue customers typically allow the customer to cancel the contract for any reason with 30 to 90 days' notice. Our continued success therefore depends significantly on our ability to meet or exceed our recurring revenue customers' expectations because most recurring revenue customers do not make long-term commitments to use our solutions. In addition, if our reputation in the supply chain management industry is harmed or diminished for any reason, our recurring revenue customers have the ability to terminate their relationship with us on short notice and seek alternative supply chain management solutions. We may also not be able to accurately predict future trends in customer renewals, and our customers' renewal rates may decline or fluctuate because of several factors, including their dissatisfaction with our services, the cost of our services compared to the cost of services offered by our competitors and reductions in our customers' spending levels. If a significant number of recurring revenue customers seek to terminate their relationship with us, our business, results of operations and financial condition can be adversely affected in a short period of time.

Our quarterly results of operations may fluctuate in the future, which could result in volatility in our stock price.

Our quarterly revenues and results of operations have varied in the past and may fluctuate as a result of a variety of factors, including the success of our more recent offerings such as our Trading Partner Analytics solution. If our quarterly revenues or results of operations fluctuate, the price of our common stock could decline substantially. Fluctuations in our results of operations may be due to a number of factors, including, but not limited to, those listed below and identified throughout this "Risk Factors" section:

- our ability to retain and increase sales to customers and attract new customers, including our ability to maintain and increase our number of recurring revenue customers;
- the timing and success of introductions of new solutions or upgrades by us or our competitors;
- the strength of the economy, in particular as it affects the retail sector;

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- the financial condition of our customers;
- changes in our pricing policies or those of our competitors;
- competition, including entry into the industry by new competitors and new offerings by existing competitors;
- the amount and timing of our expenses, including stock-based compensation and expenditures related to expanding our operations, supporting new customers, performing research and development, or introducing new solutions;
- changes in the payment terms for our solutions; and
- system or service failures, security breaches or network downtime.

Due to the foregoing factors, and the other risks discussed in this Annual Report on Form 10-K, you should not rely on comparisons of our results of operations as an indication of our future performance.

Interruptions or delays from third-party data centers could impair the delivery of our solutions and our business could suffer.

We use third-party data centers, located in Minnesota and New Jersey, as well as provision services in public cloud providers, to conduct our operations. In all cases, infrastructure and services on which our platform runs is managed by us. Our operations depend on the protection of the equipment and information we store in these third-party centers against damage or service interruptions that may be caused by fire, flood, severe storm, power loss, telecommunications failures, natural disasters, war, criminal act, military action, terrorist attack and other similar events beyond our control. In addition, third party malfeasance, such as intentional misconduct by computer hackers, unauthorized intrusions, computer viruses, or denial of service attacks, may also cause substantial service disruptions. A prolonged service disruption affecting our solutions for any of the foregoing reasons could damage our reputation with current and potential customers, expose us to liability, cause us to lose recurring revenue customers or otherwise adversely affect our business. We may also incur significant costs for using alternative equipment or taking other actions in preparation for, or in reaction to, events that damage the data centers we use.

Our cloud-based supply chain management solutions are accessed by a large number of customers at the same time. As we continue to expand the number of our customers and solutions available to our customers, we may not be able to scale our technology to accommodate the increased capacity requirements, which may result in interruptions or delays in service. In addition, the failure of our third-party data centers to meet our capacity requirements could result in interruptions or delays in our solutions or impede our ability to scale our operations. In the event that our data center arrangements are terminated, or there is a lapse of service or damage to such facilities, we could experience interruptions in our solutions as well as delays and additional expense in arranging new facilities and services.

A failure to protect the integrity and security of our customers' information and access to our customers' information systems could expose us to litigation, materially damage our reputation and harm our business, and the costs of preventing such a failure could adversely affect our results of operations.

Our business involves the collection and use of confidential information of our customers and their trading partners. The collection and use of this information sometimes requires our direct access to our customers' information systems. We cannot assure you that our efforts to protect this confidential information and access will be successful. Our security measures may be breached as a result of third-party action, including intentional misconduct by computer hackers, employee error, malfeasance or otherwise and result in someone obtaining unauthorized access to our customers' data or our data, including our intellectual property and other confidential business information, or our IT systems. Additionally, third parties may attempt to fraudulently induce employees or customers into disclosing sensitive information such as user names, passwords or other information

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in order to gain access to our customers' data or our data or IT systems. Because the techniques used to obtain unauthorized access, or to sabotage systems, change frequently and generally are not recognized until launched against a target, we may be unable to anticipate these techniques or to implement adequate preventative measures. Malicious third-parties may also conduct attacks designed to temporarily deny customers access to our services.

If any compromise of this information security were to occur, or if we fail to detect and appropriately respond to a significant data security breach, we could be subject to legal claims and government action, experience an adverse effect on our reputation and need to incur significant additional costs to protect against similar information security breaches in the future, each of which could adversely impact our financial condition, results of operations and growth prospects. Litigation resulting from such claims may be costly, time-consuming and distracting to management. In addition, because of the critical nature of data security, any perceived breach of our security measures could cause existing or potential customers not to use our solutions and could harm our reputation.

We may experience service failures or interruptions due to defects in the hardware, software, infrastructure, third party components or processes that comprise our existing or new solutions, any of which could adversely affect our business.

Technology solutions as complex as ours may contain undetected defects in the hardware, software, infrastructure, third party components or processes that are part of the solutions we provide. If these defects lead to service failures, we could experience delays or lost revenues, diversion of software engineering resources, material non-monetary concessions, negative media attention or increased service costs as a result of performance claims during the period required to correct the cause of the defects. We cannot be certain that defects will not be found in new solutions or upgraded solutions, resulting in loss of, or delay in, market acceptance, which could have an adverse effect on our business, results of operations and financial condition.

Because customers use our cloud-based supply chain management solutions for critical business processes, any defect in our solutions, any disruption to our solutions or any error in execution could cause recurring revenue customers to cancel their contracts with us, prevent potential customers from joining our network and harm our reputation. Although most of our contracts with our customers limit our liability to our customers for these defects, disruptions or errors, we nonetheless could be subject to litigation for actual or alleged losses to our customers' businesses, which may require us to spend significant time and money in litigation or arbitration or to pay significant settlements or damages. We do not currently maintain any warranty reserves. Defending a lawsuit, regardless of its merit, could be costly and divert management's attention and could cause our business to suffer.

The insurers under our existing liability insurance policy could deny coverage of a future claim that results from an error or defect in our technology or a resulting disruption in our solutions, or our existing liability insurance might not be adequate to cover all of the damages and other costs of such a claim. Moreover, we cannot assure you that our current liability insurance coverage will continue to be available to us on acceptable terms or at all. The successful assertion against us of one or more large claims that exceeds our insurance coverage, or the occurrence of changes in our liability insurance policy, including an increase in premiums or imposition of large deductible or co-insurance requirements, could have an adverse effect on our business, financial condition and operating results. Even if we succeed in litigation with respect to a claim, we are likely to incur substantial costs and our management's attention will be diverted from our operations.

Our business is dependent on our ability to maintain and scale our technical infrastructure, and any failure to effectively maintain and grow our technical infrastructure service could damage our reputation, result in a potential loss of users and engagement, and adversely affect our financial results.

Our reputation and ability to attract, retain and serve our customers is dependent upon the reliable performance of our platform and our underlying technical infrastructure. As our user base and the amount and

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types of information shared on our platform continue to grow, we will need an increasing amount of technical infrastructure, including network capacity and computing power, to continue to satisfy the needs of our users. It is possible that we may fail to effectively scale and grow our technical infrastructure to accommodate these increased demands. Any failure to effectively maintain and grow our technical infrastructure could damage our reputation, result in a potential loss of users and engagement, and adversely affect our financial results.

Our inability to adapt to rapid technological change could impair our ability to remain competitive.

The industry in which we compete is characterized by rapid technological change, frequent introductions of new products and evolving industry standards. Existing products can become obsolete and unmarketable when vendors introduce products utilizing new technologies or new industry standards emerge, and as a result, it is difficult for us to estimate the life cycles of our products. Our ability to attract new customers and increase revenues from customers will depend in significant part on our ability to anticipate industry standards and to continue to enhance existing solutions or introduce or acquire new solutions on a timely basis to keep pace with technological developments. The success of any enhancement or new solution depends on several factors, including the timely completion, introduction and market acceptance of the enhancement or solution. Any new solution we develop or acquire might not be introduced in a timely or cost-effective manner and might not achieve the broad market acceptance necessary to generate significant revenues. If any of our competitors implement new technologies before we are able to implement them, those competitors may be able to provide more effective solutions than ours at lower prices. Any delay or failure in the introduction of new or enhanced solutions could adversely affect our business, results of operations and financial condition.

If we fail to protect our intellectual property and proprietary rights adequately, our business could be adversely affected.

We believe that proprietary technology is essential to establishing and maintaining our leadership position. We seek to protect our intellectual property through trade secrets, copyrights, confidentiality, non-compete and nondisclosure agreements, trademarks, domain names and other measures, some of which afford only limited protection. We do not have any patents or registered copyrights. Despite our efforts to protect our proprietary rights, unauthorized parties may attempt to copy aspects of our technology or to obtain and use information that we regard as proprietary. We cannot assure you that our means of protecting our proprietary rights will be adequate or that our competitors will not independently develop similar or superior technology or design around our intellectual property. In addition, the laws of some foreign countries do not protect our proprietary rights to as great an extent as the laws of the United States of America. Intellectual property protections may also be unavailable, limited or difficult to enforce in some countries, which could make it easier for competitors to capture market share. Our failure to protect adequately our intellectual property and proprietary rights could adversely affect our business, financial condition and results of operations.

An assertion by a third party that we are infringing its intellectual property could subject us to costly and time-consuming litigation or expensive licenses and our business might be harmed.

The Internet supply chain management and technology industries are characterized by the existence of a large number of patents, copyrights, trademarks and trade secrets and by frequent litigation based on allegations of infringement or other violations of intellectual property rights. As we seek to extend our solutions, we could be constrained by the intellectual property rights of others.

We might not prevail in any intellectual property infringement litigation given the complex technical issues and inherent uncertainties in such litigation. Defending such claims, regardless of their merit, could be time-consuming and distracting to management, result in costly litigation or settlement, cause development delays, require us to enter into royalty or licensing agreements or require us to redesign our products to avoid infringement. If our solutions violate any third-party proprietary rights, we could be required to withdraw those solutions from the market, re-develop those solutions or seek to obtain licenses from third parties, which might

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not be available on reasonable terms or at all. Any efforts to re-develop our solutions, obtain licenses from third parties on favorable terms or license a substitute technology might not be successful and, in any case, might substantially increase our costs and harm our business, financial condition and operating results. Withdrawal of any of our solutions from the market might harm our business, financial condition and operating results.

In addition, we incorporate open source software into our platform. Given the nature of open source software, third parties might assert copyright and other intellectual property infringement claims against us based on our use of certain open source software programs. The terms of many open source licenses to which we are subject have not been interpreted by U.S. or foreign courts, and there is a risk that those licenses could be construed in a manner that imposes unanticipated conditions or restrictions on our ability to commercialize our solutions. In that event, we could be required to seek licenses from third parties in order to continue offering our solutions, to re-develop our solutions or to discontinue sales of our solutions, or to release our proprietary software code under the terms of an open source license, any of which could adversely affect our business.

Our industry is a prime target for those that seek to steal confidential information and computer malware, viruses, hacking and phishing attacks, and spamming could harm our business and cause us to lose the confidence of our users, which could significantly impact our business and results of operations.

As demonstrated by recent material and high-profile data security breaches within the retail industry, computer malware, viruses, and computer hacking and phishing attacks have become more prevalent in our industry, have occurred on our systems in the past, and may occur on our systems in the future. Furthermore, given the interconnected nature of the retail supply chain and our significant presence in the retail industry, we believe that we are a particularly attractive target for such attacks. In addition, our connection to the retail industry could present the opportunity for an attack on our system to serve as a way to obtain access into our users' systems, which could have a material adverse effect on our financial condition and growth prospectus. Businesses in our industry have experienced material sales declines after discovering data breaches, and our business could be similarly impacted. The security costs to reduce the likelihood of an attack are high and may continue to increase. Reputational value is based in large part on perceptions of subjective qualities. While reputations may take decades to build, any negative incidents can quickly erode trust and confidence, particularly if they result in adverse mainstream and social media publicity, governmental investigations or litigation. Though it is difficult to determine what, if any, harm may directly result from any specific interruption or attack, any failure to maintain performance, reliability, security and availability of our products and technical infrastructure to the satisfaction of our users may harm our reputation, impair our ability to retain existing customers and attract new customers and expose us to legal claims and government action, each of which could have a material adverse impact on our financial condition, results of operations and growth prospects.

Our new products and changes to existing products could fail to attract or retain users or generate revenue.

Our ability to retain, increase and engage our customers and to increase our revenues will depend heavily on our ability to create successful new products. We may introduce significant changes to our existing products or develop and introduce new and unproven products which include or use technologies with which we have little or no prior development or operating experience. If new or enhanced products fail to engage customers, we may fail to attract or retain customers or to generate sufficient revenues, operating margin, or other value to justify our investments and our business may be adversely affected. In the future, we may invest in new products and initiatives to generate revenue, but there is no guarantee these approaches will be successful. If we are not successful with new approaches to monetization, we may not be able to maintain or grow our revenues as anticipated or recover any associated development costs and our financial results could be adversely affected.

Our software is highly technical, and if it contains undetected errors, our business could be adversely affected.

Our products incorporate software that is highly technical and complex. Our software has contained, and may now or in the future contain, undetected errors, bugs or vulnerabilities. Some errors in our software code

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may only be discovered after the code has been released. Any defects or errors discovered in our code after release could result in damage to our reputation, loss of customers, loss of revenue or liability for damages, any of which could adversely affect our business and financial results.

The market for cloud-based supply chain management solutions is at an early stage of development. If this market does not develop or develops more slowly than we expect, our revenues may decline or fail to grow and we may incur operating losses.

We derive, and expect to continue to derive, substantially all of our revenues from providing cloud-based supply chain management solutions to suppliers, retailers, distributors and logistics firms. The market for cloud-based supply chain management solutions is in an early stage of development, and it is uncertain whether these solutions will achieve and sustain high levels of demand and market acceptance. Our success will depend on the willingness of retailers and their trading partners to accept our cloud-based supply chain management solutions as an alternative to traditional licensed hardware and software solutions.

Some suppliers, retailers, distributors, or logistics firms may be reluctant or unwilling to use our cloud-based supply chain management solutions for a number of reasons, including existing investments in supply chain management technology. Supply chain management functions traditionally have been performed using purchased or licensed hardware and software implemented by each supplier. Because this traditional approach often requires significant initial investments to purchase the necessary technology and to establish systems that comply with retailers' unique requirements, suppliers may be unwilling to abandon their current solutions for our cloud-based supply chain management solutions.

Other factors that may limit market acceptance of our cloud-based supply chain management solutions include:

- our ability to maintain high levels of customer satisfaction;
- our ability to maintain continuity of service for all users of our platform;
- the price, performance and availability of competing solutions; and
- our ability to assuage suppliers' confidentiality concerns about information stored outside of their controlled computing environments.

If retailers and their trading partners do not perceive the benefits of our cloud-based supply chain management solutions, or if retailers and their trading partners are unwilling to accept our platform as an alternative to the traditional approach, the market for our solutions might not continue to develop or might develop more slowly than we expect, either of which would significantly adversely affect our revenues and growth prospects.

Privacy concerns and laws, evolving regulation of cloud computing, cross-border data transfer restrictions and other domestic or foreign regulations may limit the use and adoption of our solutions and adversely affect our business.

Regulation related to the provision of services on the Internet is increasing, as federal, state and foreign governments continue to adopt new laws and regulations addressing data privacy and the collection, processing, storage and use of personal information. In some cases foreign data privacy laws and regulations, such as the European Union's Data Protection Directive, and the country-specific regulations that implement that directive, also govern the processing of personal information. Further, laws are increasingly aimed at the use of personal information for marketing purposes, such as the European Union's e-Privacy Directive, and the country-specific regulations that implement that directive. Such laws and regulations are subject to differing interpretations and may be inconsistent among jurisdictions. These and other requirements could reduce demand for our solutions or restrict our ability to store and process data or, in some cases, impact our ability to offer our services and solutions in certain locations.

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In addition to government activity, privacy advocacy and other industry groups have established or may establish new self-regulatory standards that may place additional burdens on us. Our customers may expect us to meet voluntary certification or other standards established by third parties. If we are unable to maintain these certifications or meet these standards, it could adversely affect our ability to provide our solutions to certain customers and could harm our business.

The costs of compliance with and other burdens imposed by laws, regulations and standards may limit the use and adoption of our services and reduce overall demand for them, or lead to significant fines, penalties or liabilities for any noncompliance.

Furthermore, concerns regarding data privacy may cause our customers' customers to resist providing the data necessary to allow our customers to use our service effectively. Even the perception that the privacy of personal information is not satisfactorily protected or does not meet regulatory requirements could inhibit sales of our products or services, and could limit adoption of our cloud-based solutions.

Evolving regulation of the Internet may increase our expenditures related to compliance efforts, which may adversely affect our financial condition.

As Internet commerce continues to evolve, increasing regulation by federal, state or foreign agencies becomes more likely. We are particularly sensitive to these risks because the Internet is a critical component of our cloud-based business model. For example, we believe that increased regulation is likely in the area of data privacy, and laws and regulations applying to the solicitation, collection, processing or use of personal or consumer information could affect our customers' ability to use and share data, potentially reducing demand for solutions accessed via the Internet and restricting our ability to store, process and share data with our clients via the Internet. In addition, taxation of services provided over the Internet or other charges imposed by government agencies or by private organizations for accessing the Internet may be imposed. Any regulation imposing greater fees for Internet use or restricting information exchange over the Internet could result in a decline in the use of the Internet and the viability of Internet-based services, which could harm our business.

Industry-specific regulation is evolving and unfavorable industry-specific laws, regulations or interpretive positions could harm our business.

Our customers and potential customers do business in a variety of industries. Regulators in certain industries have adopted and may in the future adopt regulations or interpretive positions regarding the use of cloud computing and other outsourced services. The costs of compliance with, and other burdens imposed by, industry-specific laws, regulations and interpretive positions may limit customers' use and adoption of our services and reduce overall demand for our services. In addition, an inability to satisfy the standards of certain voluntary third-party certification bodies that our customers may expect may have an adverse impact on our business. If in the future we are unable to achieve or maintain these industry-specific certifications or other requirements or standards relevant to our customers, it may harm our business.

In some cases, industry-specific laws, regulations or interpretive positions may also apply directly to us as a service provider. Any failure or perceived failure by us to comply with such requirements could have an adverse impact on our business.

We rely on third party infrastructure, software and services that could take a significant time to replace or upgrade.

We rely on infrastructure, software and services licensed from third parties to offer our cloud-based supply chain management solutions. This infrastructure, software and services, as well as maintenance rights for this infrastructure, software and services, may not continue to be available to us on commercially reasonable terms, or at all. If we lose the right to use or upgrade any of these licenses, our customers could experience delays or be unable to access our solutions until we can obtain and integrate equivalent technology. There might not always

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be commercially reasonable hardware or software alternatives to the third-party infrastructure, software and services that we currently license. Any such alternatives could be more difficult or costly to replace than the third-party infrastructure, software and services we currently license, and integration of the alternatives into our platform could require significant work and substantial time and resources. Any delays or failures associated with our platform could injure our reputation with customers and potential customers and result in an adverse effect on our business, results of operations and financial condition.

We may pursue acquisitions and our potential inability to successfully integrate newly acquired companies or businesses could adversely affect our financial results.

We may pursue acquisitions of other companies or their businesses in the future. If we complete acquisitions, we face many risks commonly encountered with growth through acquisitions. These risks include:

- incurring significantly higher than anticipated capital expenditures and operating expenses;
- failing to assimilate the operations, customers, and personnel of the acquired company or business;
- disrupting our ongoing business;
- dissipating our management resources;
- dilution to existing stockholders from the issuance of equity securities;
- liabilities or other problems associated with the acquired business;
- incurring debt on terms unfavorable to us or that we are unable to repay;
- becoming subject to adverse tax consequences, substantial depreciation or deferred compensation charges;
- improper compliance with laws and regulations;
- failing to maintain uniform standards, controls and policies; and
- impairing relationships with employees and customers as a result of changes in management.

Fully integrating an acquired company or business into our operations may take a significant amount of time. We cannot assure you that we will be successful in overcoming these risks or any other problems encountered with acquisitions. To the extent we do not successfully avoid or overcome the risks or problems related to any acquisitions, our results of operations and financial condition could be adversely affected. Future acquisitions also could impact our financial position and capital needs, and could cause substantial fluctuations in our quarterly and yearly results of operations. Acquisitions could include significant goodwill and intangible assets, which may result in future impairment charges that would reduce our stated earnings.

Because our long-term success depends, in part, on our ability to expand the sales of our solutions to customers located outside of the United States of America, our business will be susceptible to risks associated with international operations.

We have limited experience operating in foreign jurisdictions. Customers in countries outside of North America accounted for 6%, 6%, and 3% of our revenues for 2016, 2015, and 2014, respectively. In 2014, we purchased substantially all of the assets of Leadtec, a privately-held provider of cloud-based integration solutions in Australia and New Zealand and in 2016, we acquired all the shares of Toolbox Solutions, Inc., a privately-held provider of cloud-based analytic solutions, which is based in Canada. We also undertake software development activities in the Ukraine. Our inexperience in operating our business outside of North America increases the risk that our current and any future international expansion efforts will not be successful. Conducting international operations subjects us to new risks that, generally, we have not faced in the United States of America, including:

- fluctuations in currency exchange rates;
- unexpected changes in foreign regulatory requirements;

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- longer accounts receivable payment cycles and difficulties in collecting accounts receivable;
- difficulties in managing and staffing international operations;
- differing technology standards;
- potentially adverse tax consequences, including the complexities of foreign value added tax systems and restrictions on the repatriation of earnings;
- localization of our solutions, including translation into foreign languages and associated expenses;
- the burdens of complying with a wide variety of foreign laws and different legal standards, including laws and regulations related to privacy;
- increased financial accounting and reporting burdens and complexities;
- political, social and economic instability abroad (including the current hostilities in Ukraine), terrorist attacks and security concerns in general;
- greater potential for corruption and bribery; and
- reduced or varied protection for intellectual property rights in some countries.

The occurrence of any one of these risks could negatively affect our international business and, consequently, our results of operations generally. Additionally, operating in international markets also requires significant management attention and financial resources. We cannot be certain that the investment and additional resources required in establishing, acquiring or integrating operations in other countries will produce desired levels of revenues or profitability.

In addition, we operate in parts of the world, such as Ukraine, that are recognized as having governmental corruption problems to some degree and where local customs and practices may not foster strict compliance with anti-corruption laws. Our continued operation and potential expansion outside the United States could increase the risk of such violations in the future. Despite our training and compliance programs, we cannot assure you that our internal control policies and procedures will protect us from unauthorized reckless or criminal acts committed by our employees or agents. In the event that we believe or have reason to believe that our employees or agents have or may have violated applicable anti-corruption laws, including the U.S. Foreign Corrupt Practices Act, we may be required to investigate or have outside counsel investigate the relevant facts and circumstances, which can be expensive and require significant time and attention from senior management. Violations of these laws may result in severe criminal or civil sanctions, which could disrupt our business and result in a material adverse effect on our reputation, business, results of operations or financial condition.

The use of open source software in our products may expose us to additional risks and harm our intellectual property.

Some of our products use or incorporate software that is subject to one or more open source licenses. Open source software is typically freely accessible, usable and modifiable. Certain open source software licenses require a user who intends to distribute the open source software as a component of the user's software to disclose publicly part or all of the source code to the user's software. In addition, certain open source software licenses require the user of such software to make any derivative works of the open source code available to others on unfavorable terms or at no cost. This can subject previously proprietary software to open source license terms. Furthermore, if we fail to comply with these licenses, we may be subject to certain conditions, including requirements that we offer our services that incorporate the open source software for no cost, that we make available source code for modifications or derivative works we create based upon, incorporating or using the open source software and that we license such modifications or alterations under the terms of the particular open source license. If an author or third party that distributes such open source software were to allege that we had not complied with the conditions of one or more of these licenses, we could be required to incur significant legal

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expenses defending against such allegations and could be subject to significant damages, enjoined from the sale of our services that contained the open source software and required to comply with the foregoing conditions, which could disrupt the distribution and sale of some of our services.

While we monitor the use of all open source software in our products, processes and technology and try to ensure that no open source software is used in such a way as to require us to disclose the source code to the related product or solution, such use could inadvertently occur. Additionally, if a third-party software provider has incorporated certain types of open source software into software we license from such third party for our products and solutions, we could, under certain circumstances, be required to disclose the source code to our products and solutions. This could harm our intellectual property position and have a material adverse effect on our business, results of operations, cash flow and financial condition.

Our operations may be adversely affected by ongoing developments in Ukraine.

Ukraine has been undergoing heightened political turmoil since the removal of President Yanukovich from power by the Ukrainian parliament in late February 2014, which was followed by reports of Russian military activity in the Crimean region. The situation in Ukraine is rapidly developing and we cannot predict the outcome of developments there or the reaction to such developments by U.S., European, U.N. or other international authorities.

We currently engage in software development activities in the Ukraine and have an office in Kiev with 60 employees. We relocated our office to Kiev from Kharkiv due, in part, to the hostilities. We continue to monitor the situation closely. We have no way to predict the progress or outcome of the situation, as the political and civil unrest and reported military activities are fluid and beyond our control. Prolonged or expanded unrest, military activities, or broad-based sanctions, should they be implemented, could have a material adverse effect on our operations.

We have incurred operating losses in the past and may incur operating losses in the future.

We began operating our supply chain management solution business in 1997. Throughout most of our history, we have experienced net losses and negative cash flows from operations. As of December 31, 2016, we had an accumulated deficit of \$33.7 million. We expect our operating expenses to continue to increase in the future as we expand our operations and increase our customer base due to expected increased sales and marketing expenses, operations costs, research and development costs and general and administration costs. If our revenues do not continue to grow to offset these increased expenses, we may not be profitable. We cannot assure you that we will be able to maintain profitability. You should not consider recent revenue growth as indicative of our future performance. In fact, in future periods, we may not have any revenue growth, or our revenues could decline. In addition, our ability to achieve profitability is subject to a number of the risks and uncertainties discussed herein, many of which are beyond our control.

Our ability to use our U.S. net operating loss carryforwards might be limited.

As of December 31, 2016, we had net operating loss carryforwards of \$70.7 million for U.S. federal tax purposes. We also had \$19.2 million of various state net operating loss carryforwards. The loss carryforwards for federal tax purposes will expire between 2019 and 2036 if not utilized. The loss carryforwards for state tax purposes will expire between 2017 and 2036 if not utilized. To the extent these net operating loss carryforwards are available, we intend to use them to reduce the corporate income tax liability associated with our operations. Section 382 of the U.S. Internal Revenue Code generally imposes an annual limitation on the amount of net operating loss carryforwards that might be used to offset taxable income when a corporation has undergone significant changes in stock ownership. We have performed a Section 382 analysis for the time period from our inception through December 8, 2010. During this time period it was determined that we had six separate ownership changes under Section 382. We have not updated the Section 382 analysis subsequent to December 8, 2010; however, we believe there have not been any events subsequent to that date that would materially impact

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the analysis. We believe that approximately \$17.6 million of federal losses will expire unused due to Section 382 limitations. The maximum annual limitation of federal net operating losses under Section 382 is approximately \$990,000. This limitation could be further restricted if any ownership changes occur in future years. To the extent our use of net operating loss carryforwards is significantly limited, our taxable income could be subject to corporate income tax earlier than it would if we were able to use net operating loss carryforwards, which could result in lower profits.

The markets in which we participate are highly competitive, and our failure to compete successfully would make it difficult for us to add and retain customers and would reduce or impede the growth of our business.

The markets for supply chain management solutions are increasingly competitive and global. We expect competition to increase in the future both from existing competitors and new companies that may enter our markets. Increased competition could result in pricing pressure, reduced sales, lower margins or the failure of our solutions to achieve or maintain broad market acceptance. We face competition from:

- cloud service providers that deliver business-to-business information systems using a multi-tenant approach;
- traditional on-premise software providers; and
- managed service providers that combine traditional on-premise software with professional information technology services.

To remain competitive, we will need to invest continuously in software development, marketing, customer service and support and product delivery infrastructure. However, we cannot assure you that new or established competitors will not offer solutions that are superior to or lower in price than ours. We may not have sufficient resources to continue the investments in all areas of software development and marketing needed to maintain our competitive position. In addition, some of our competitors are better capitalized than us, which may provide them with an advantage in developing, marketing or servicing new solutions. Increased competition could reduce our market share, revenues and operating margins, increase our costs of operations and otherwise adversely affect our business.

Mergers or other strategic transactions involving our competitors could weaken our competitive position, which could harm our operating results.

Our industry is highly fragmented, and we believe it is likely that our existing competitors will continue to consolidate or will be acquired. In addition, some of our competitors may enter into new alliances with each other or may establish or strengthen cooperative relationships with systems integrators, third-party consulting firms or other parties. Any such consolidation, acquisition, alliance or cooperative relationship could lead to pricing pressure, loss of customers and our loss of market share and could result in a competitor with greater financial, technical, marketing, service and other resources, all of which could have a material adverse effect on our business, operating results and financial condition.

Economic weakness and uncertainty could adversely affect our revenue, lengthen our sales cycles and make it difficult for us to forecast operating results accurately.

Our revenues depend significantly on general economic conditions and the health of retailers. Economic weakness and constrained retail spending adversely affected revenue growth rates in late 2008 and similar circumstances may result in slower growth, or reductions, in revenues and gross profits in the future. We have experienced, and may experience in the future, reduced spending in our business due to financial turmoil affecting the U.S. and global economy, and other macroeconomic factors affecting spending behavior. Uncertainty about future economic conditions makes it difficult for us to forecast operating results and to make decisions about future investments. In addition, economic conditions or uncertainty may cause customers and potential customers to reduce or delay technology purchases, including purchases of our solutions. Our sales cycle may lengthen if purchasing decisions are delayed as a result of uncertain information technology or

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development budgets or contract negotiations become more protracted or difficult as customers institute additional internal approvals for information technology purchases. Delays or reductions in information technology spending could have a material adverse effect on demand for our solutions, and consequently our results of operations, prospects and stock price.

Our continued growth could strain our personnel resources and infrastructure, and if we are unable to implement appropriate controls and procedures to manage our growth, we will not be able to implement our business plan successfully.

We have experienced a period of rapid growth in our headcount and operations. To the extent that we are able to sustain such growth, it will place a significant strain on our management, administrative, operational and financial infrastructure. Our success will depend in part upon the ability of our senior management to manage this growth effectively. To do so, we must continue to hire, train and manage new employees as needed. If our new hires perform poorly, or if we are unsuccessful in hiring, training, managing and integrating these new employees, or if we are not successful in retaining our existing employees, our business would be harmed. To manage the expected growth of our operations and personnel, we will need to continue to improve our operational, financial and management controls and our reporting systems and procedures. The additional headcount we are adding will increase our cost base, which will make it more difficult for us to offset any future revenue shortfalls by reducing expenses in the short term. If we fail to successfully manage our growth, we will be unable to execute our business plan.

If we fail to retain our Chief Executive Officer and other key personnel, our business would be harmed and we might not be able to implement our business plan successfully.

Given the complex nature of the technology on which our business is based and the speed with which such technology advances, our future success is dependent, in large part, upon our ability to attract and retain highly qualified managerial, technical and sales personnel. The loss of any member of our senior management team or key personnel might significantly delay or prevent the achievement of our business objectives and could materially harm our business and our customer relationships. In addition, because of the nature of our business, the loss of any significant number of our existing engineering, project management and sales personnel could have an adverse effect on our business, results of operations and financial condition. Competition for talented personnel is intense, and we cannot be certain that we can retain our managerial, technical and sales personnel or that we can attract, assimilate or retain such personnel in the future. Our inability to attract and retain such personnel could have an adverse effect on our business, results of operations and financial condition.

Our failure to maintain adequate internal control over financial reporting in accordance with Section 404 of the Sarbanes-Oxley Act of 2002 or to prevent or detect material misstatements in our annual or interim financial statements in the future could result in inaccurate financial reporting, or could otherwise harm our business.

Ensuring that we have internal financial and accounting controls and procedures adequate to produce accurate financial statements on a timely basis is a costly and time-consuming effort that needs to be re-evaluated frequently. The Sarbanes-Oxley Act requires, among other things, that we maintain effective internal control over financial reporting and disclosure controls and procedures. In particular, we are required to perform annual system and process evaluation and testing of our internal control over financial reporting to allow management and our independent registered public accounting firm to report on the effectiveness of our internal control over financial reporting, as required by Section 404 of the Sarbanes-Oxley Act. Furthermore, implementing any appropriate future changes to our internal control over financial reporting may entail substantial costs in order to modify our existing accounting systems, may take a significant period of time to complete and may distract our officers, directors and employees from the operation of our business. If we are not able to comply with the requirements of Section 404 in the future, or if material weaknesses are identified, the market price of our common stock could decline.

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Our failure to raise additional capital or generate cash flows necessary to expand our operations and invest in new technologies could reduce our ability to compete successfully and adversely affect our results of operations.

We may need to raise additional funds, and we may not be able to obtain additional debt or equity financing on favorable terms, if at all. If we raise additional equity financing, our security holders may experience significant dilution of their ownership interests and the value of shares of our common stock could decline. If we engage in debt financing, we may be required to accept terms that restrict our ability to incur additional indebtedness, force us to maintain specified liquidity or other ratios or restrict our ability to pay dividends or make acquisitions. If we need additional capital and cannot raise it on acceptable terms, we may not be able to, among other things:

- develop and enhance our solutions;
- continue to expand our technology development, sales and marketing organizations;
- acquire complementary technologies, products or businesses;
- hire, train and retain employees; or
- respond to competitive pressures or unanticipated working capital requirements.

Our inability to do any of the foregoing could reduce our ability to compete successfully and adversely affect our results of operations.

If the open source community expands into enterprise application and supply chain software, our fee revenues may decline.

The open source community is comprised of many different formal and informal groups of software developers and individuals who have created a wide variety of software and have made that software available for use, distribution and modification, often free of charge. Open source software, such as the Linux operating system, has been gaining in popularity among business users. If developers contribute enterprise and supply chain application software to the open source community, and that software has competitive features and scale to support business users in our markets, we may need to change our product pricing and distribution strategy to compete successfully, and our fee revenues may decline as a result.

Our stock price may be volatile.

Shares of our common stock were sold in our April 2010 initial public offering at a price of \$12.00 per share and through December 31, 2016, our common stock has traded as high as \$79.98 per share and as low as \$8.45 per share. An active, liquid and orderly market for our common stock may not be sustained, which could depress the trading price of our common stock. Some of the factors that may cause the market price of our common stock to fluctuate include:

- fluctuations in our quarterly financial results or the quarterly financial results of companies perceived to be similar to us;
- fluctuations in our recorded revenue, even during periods of significant sales order activity;
- fluctuations in stock market volume;
- changes in estimates of our financial results or recommendations by securities analysts;
- failure of any of our solutions to achieve or maintain market acceptance;
- changes in market valuations of similar companies;
- success of competitive products or services;
- changes in our capital structure, such as future issuances of securities or the incurrence of debt;

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- announcements by us or our competitors of significant solutions, contracts, acquisitions or strategic alliances;
- regulatory developments in the United States of America, foreign countries or both;
- litigation involving our company, our general industry or both;
- additions or departures of key personnel;
- investors' general perception of us; and
- changes in general economic, industry and market conditions.

In addition, if the market for software stocks or the stock market in general experiences a loss of investor confidence, the trading price of our common stock could decline for reasons unrelated to our business, financial condition or results of operations. If any of the foregoing occurs, it could cause our stock price to fall and may expose us to class action lawsuits that, even if unsuccessful, could be costly to defend and a distraction to management.

If securities or industry analysts cease publishing research or reports about us, our business or our market, or if they publish negative evaluations of our stock, the price of our stock and trading volume could decline.

The trading market for our common stock depends in part on the research and reports that securities or industry analysts publish about us or our business. If one or more of the analysts who covers us downgrades our stock or publishes incorrect or unfavorable research about our business, our stock price would likely decline. In addition, if one or more of these analysts ceases coverage of our company or fails to publish reports on us regularly, demand for our stock could decrease, which could cause our stock price or trading volume to decline.

Future sales of our common stock by our existing stockholders could cause our stock price to decline.

If our stockholders sell substantial amounts of our common stock in the public market, the market price of our common stock could decrease significantly. The perception in the public market that our stockholders might sell shares of our common stock could also depress the market price of our common stock. As of December 31, 2016, we had approximately 3.9 million shares of our common stock issuable under approved equity compensation plans which are covered by effective registration statements.

Our charter documents and Delaware law may inhibit a takeover that stockholders consider favorable.

Provisions of our certificate of incorporation and bylaws and applicable provisions of Delaware law may delay or discourage transactions involving an actual or potential change in our control or change in our management, including transactions in which stockholders might otherwise receive a premium for their shares, or transactions that our stockholders might otherwise deem to be in their best interests, and may ultimately result in the market price of our common stock being lower than it would be without these provisions. These provisions:

- permit our board of directors to issue up to 5,000,000 shares of preferred stock, with any rights, preferences and privileges as our board may designate, including the right to approve an acquisition or other change in our control;
- provide that the authorized number of directors may be changed by resolution of the board of directors;
- provide that all vacancies, including newly created directorships, may, except as otherwise required by law, be filled by the affirmative vote of a majority of directors then in office, even if less than a quorum;
- provide that stockholders seeking to present proposals before a meeting of stockholders or to nominate candidates for election as directors at a meeting of stockholders must provide notice in writing in a timely manner, and also specify requirements as to the form and content of a stockholder's notice; and
- do not provide for cumulative voting rights.

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In addition, Section 203 of the Delaware General Corporation Law generally limits our ability to engage in any business combination with certain persons who own 15% or more of our outstanding voting stock or any of our associates or affiliates who at any time in the past three years have owned 15% or more of our outstanding voting stock. These provisions may have the effect of entrenching our management team and may deprive you of the opportunity to sell your shares to potential acquirers at a premium over prevailing prices. This potential inability to obtain a control premium could reduce the price of our common stock.

We do not intend to declare dividends on our stock in the foreseeable future.

We currently intend to retain all future earnings for the operation and expansion of our business and, therefore, do not anticipate declaring or paying cash dividends on our common stock in the foreseeable future. Investors may need to sell all or part of their holdings of our common stock after price appreciation, which may never occur, as the only way to realize any future gains on their investment. Any payment of future cash dividends on our common stock will be at the discretion of our board of directors and will depend upon our results of operations, earnings, capital requirements, financial condition, future prospects, contractual restrictions and other factors deemed relevant by our board of directors. Therefore, you should not expect to receive dividend income from shares of our common stock.

Item 1B. *Unresolved Staff Comments*

None.

Item 2. *Properties*

Our corporate headquarters, including our principal administrative, marketing, sales, technical support and research and development facilities, are located in Minneapolis, MN where we lease approximately 166,000 square feet under an agreement that expires on April 30, 2020. Our current lease agreement includes a right of first offer to lease certain additional space, which we exercised, and two options to extend the term of the lease for three years at a market rate determined in accordance with the lease.

We also have operations in or near:

- Little Falls, New Jersey, where we lease approximately 26,000 square feet under an agreement that expires on June 30, 2023;
- Toronto, Ontario, where we lease approximately 17,000 square feet under an agreement that expires on December 31, 2021; and
- Melbourne, Australia, where we lease approximately 11,000 square feet under an agreement that expires on October 15, 2021.

We believe that our current facilities are suitable and adequate to meet our current needs, and that suitable additional or substitute space will be available as needed to accommodate expansion of our operations.

Item 3. *Legal Proceedings*

We are not currently subject to any material legal proceedings. From time to time, we may be named as a defendant in legal actions or otherwise be subject to claims arising from our normal business activities. We believe that we have obtained adequate insurance coverage or rights to indemnification in connection with potential legal proceedings that may arise.

Item 4. *Mine Safety Disclosures*

Not applicable.

PART II

Item 5. Market for Registrant’s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities

Market Information. Our common stock has traded on the Nasdaq Global Market under the symbol “SPSC” since April 22, 2010, the date of our initial public offering. The following table sets forth, for the periods indicated, the high and low sales prices for our common stock as reported on the Nasdaq Global Market.

| | <u>High</u> | <u>Low</u> |
|----------------|-------------|------------|
| Fiscal 2015 | | |
| First Quarter | \$70.38 | \$52.83 |
| Second Quarter | \$72.84 | \$63.54 |
| Third Quarter | \$77.80 | \$65.17 |
| Fourth Quarter | \$78.29 | \$65.43 |
| Fiscal 2016 | | |
| First Quarter | \$69.48 | \$38.35 |
| Second Quarter | \$60.72 | \$40.94 |
| Third Quarter | \$74.85 | \$58.91 |
| Fourth Quarter | \$73.92 | \$61.40 |

Stockholders of Record. As of February 10, 2017, we had 76 stockholders of record of our common stock, excluding holders whose stock is held either in nominee name and/or street name brokerage accounts.

Dividends. We have not historically paid dividends on our common stock. We currently intend to retain our future earnings, if any, to finance the operation and expansion of our business, and, therefore, we do not expect to pay cash dividends on our common stock in the foreseeable future. Payment of future cash dividends, if any, will be at the discretion of our board of directors after taking into account various factors, including our financial condition, operating results, current and anticipated cash needs, outstanding indebtedness and plans for expansion and restrictions imposed by lenders, if any.

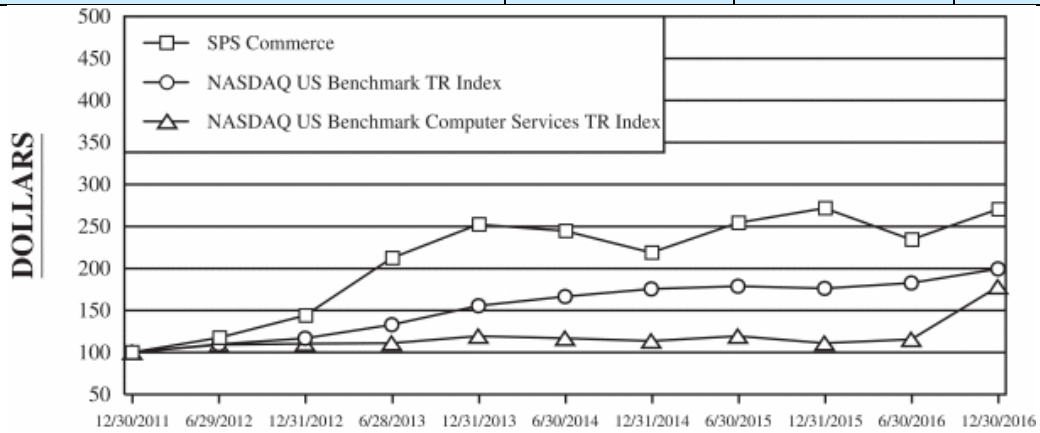
Stock Performance Graph and Cumulative Total Return

Notwithstanding any statement to the contrary in any of our previous or future filings with the SEC, the following information relating to the price performance of our common stock shall not be deemed to be “filed” with the SEC or to be “soliciting material” under the Securities Exchange Act of 1934, as amended, or the Exchange Act, and it shall not be deemed to be incorporated by reference into any of our filings under the Securities Act of 1933, as amended, or the Securities Act, or the Exchange Act, except to the extent we specifically incorporate it by reference into such filing.

The graph below compares the cumulative total stockholder return of our common stock with that of the NASDAQ US Benchmark TR Index and the NASDAQ US Benchmark Computer Services TR Index from December 30, 2011 through December 30, 2016, utilizing the last trading day of each respective year. The graph assumes that \$100 was invested in shares of our common stock, the NASDAQ US Benchmark TR Index and the NASDAQ US Benchmark Computer Services TR Index at the close of market on December 30, 2011, and that dividends, if any, were reinvested. The comparisons in this graph are based on historical data and are not intended to forecast or be indicative of future performance of our common stock.

**Comparison of Cumulative Total Returns of SPS Commerce, Inc., NASDAQ US Benchmark TR Index and
NASDAQ US Benchmark Computer Services TR Index**

| | SPS Commerce | NASDAQ US Benchmark TR Index | NASDAQ US Benchmark Computer Services TR Index |
|------------|--------------|------------------------------|--|
| 12/30/2011 | 100.0 | 100.0 | 100.0 |
| 6/29/2012 | 117.1 | 109.4 | 109.0 |
| 12/31/2012 | 143.6 | 116.4 | 110.1 |
| 6/28/2013 | 211.9 | 132.9 | 110.8 |
| 12/31/2013 | 251.6 | 155.4 | 119.0 |
| 6/30/2014 | 243.5 | 166.3 | 116.8 |
| 12/31/2014 | 218.2 | 174.8 | 113.2 |
| 6/30/2015 | 253.6 | 178.1 | 119.3 |
| 12/31/2015 | 270.6 | 175.6 | 110.8 |
| 6/30/2016 | 233.5 | 182.3 | 115.6 |
| 12/30/2016 | 269.3 | 198.5 | 177.6 |



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Use of Proceeds from Sales of Registered Securities

Not applicable.

Stock Repurchases

None.

Item 6. Selected Financial Data

The following selected financial data should be read together with our audited financial statements and the related notes and with “*Management’s Discussion and Analysis of Financial Condition and Results of Operations*” which are included elsewhere in this Annual Report on Form 10-K. Our historical results are not necessarily indicative of results to be expected for any future period.

The statements of income data for each of the years ended December 31, 2016, 2015, and 2014, the balance sheet data as of December 31, 2016 and 2015, and the operating data relating to Adjusted EBITDA and non-GAAP income per diluted share for each of the years ended December 31, 2016, 2015 and 2014 have been derived from our audited annual consolidated financial statements, which are included in this Annual Report on Form 10-K.

The statements of income data for the years ended December 31, 2013 and 2012, the balance sheet data as of December 31, 2014, 2013 and 2012, and the operating data relating to Adjusted EBITDA and non-GAAP income per diluted share for each of the years ended December 31, 2013 and 2012 have been derived from our audited annual consolidated financial statements which are not included in this Annual Report on Form 10-K, but which have been included in prior Annual Reports on Form 10-K filed with the SEC.

Adjusted EBITDA and non-GAAP income per diluted share are non-GAAP financial measures. We believe that these non-GAAP measures provide useful information to management and investors regarding certain financial and business trends relating to our financial condition and results of operations. Our management uses these non-GAAP measures to compare the company’s performance to that of prior periods for trend analyses and planning purposes. Adjusted EBITDA is also used for purposes of determining executive and senior management incentive compensation. These measures are also presented to our board of directors.

These non-GAAP measures should not be considered a substitute for, or superior to, financial measures calculated in accordance with generally accepted accounting principles in the United States of America. These non-GAAP financial measures exclude significant expenses and income that are required by accounting principles generally accepted in the United States of America (“GAAP”) to be recorded in the company’s financial statements and are subject to inherent limitations. Investors should review the reconciliations of these non-GAAP financial measures to the comparable GAAP financial measures that are included below.

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The operating data relating to recurring revenue customers for all periods presented is unaudited and has been derived from our internal records of our operations.

| | Year Ended December 31, | | | | |
|---|---------------------------------------|-----------|-----------|-----------|----------|
| | 2016 | 2015 | 2014 | 2013 | 2012 |
| | (In thousands, except per share data) | | | | |
| Statements of Income Data | | | | | |
| Revenues | \$193,295 | \$158,518 | \$127,947 | \$104,391 | \$77,106 |
| Cost of revenues(1) | 64,346 | 50,043 | 39,991 | 31,781 | 22,040 |
| Gross profit | 128,949 | 108,475 | 87,956 | 72,610 | 55,066 |
| Operating expenses | | | | | |
| Sales and marketing(1) | 65,886 | 55,374 | 46,990 | 39,621 | 30,037 |
| Research and development(1) | 21,981 | 17,954 | 13,494 | 10,870 | 8,166 |
| General and administrative(1) | 28,827 | 24,817 | 20,233 | 17,189 | 13,524 |
| Amortization of intangible assets(2) | 4,738 | 3,307 | 2,856 | 3,158 | 1,767 |
| Total operating expenses | 121,432 | 101,452 | 83,573 | 70,838 | 53,494 |
| Income from operations | 7,517 | 7,023 | 4,383 | 1,772 | 1,572 |
| Other income (expense) | | | | | |
| Interest income, net | 601 | 197 | 187 | 112 | 19 |
| Other income (expense), net(3) | 732 | (145) | (458) | (147) | (248) |
| Total other income (expense), net | 1,333 | 52 | (271) | (35) | (229) |
| Income before income taxes | 8,850 | 7,075 | 4,112 | 1,737 | 1,343 |
| Income tax expense | (3,140) | (2,436) | (1,408) | (686) | (121) |
| Net income | \$ 5,710 | \$ 4,639 | \$ 2,704 | \$ 1,051 | \$ 1,222 |
| Net income per share | | | | | |
| Basic | \$ 0.34 | \$ 0.28 | \$ 0.17 | \$ 0.07 | \$ 0.09 |
| Diluted | \$ 0.33 | \$ 0.27 | \$ 0.16 | \$ 0.07 | \$ 0.09 |
| Weighted average common shares outstanding | | | | | |
| Basic | 16,947 | 16,565 | 16,236 | 15,201 | 13,056 |
| Diluted | 17,241 | 17,032 | 16,814 | 15,931 | 13,910 |

| | As of December 31, | | | | |
|----------------------------|--------------------|-----------|-----------|-----------|-----------|
| | 2016 | 2015 | 2014 | 2013 | 2012 |
| | (In thousands) | | | | |
| Balance Sheet Data | | | | | |
| Cash and cash equivalents | \$115,877 | \$121,538 | \$130,795 | \$131,294 | \$ 66,050 |
| Working capital | 153,772 | 142,552 | 137,634 | 137,160 | 77,040 |
| Total assets | 298,229 | 261,731 | 243,775 | 223,330 | 159,201 |
| Long-term liabilities | 16,937 | 15,312 | 14,124 | 11,642 | 9,913 |
| Total stockholders' equity | 249,267 | 222,185 | 205,091 | 192,773 | 134,817 |

| | Year Ended December 31, | | | | |
|--------------------------------------|---|----------|----------|----------|----------|
| | 2016 | 2015 | 2014 | 2013 | 2012 |
| | (Unaudited, adjusted EBITDA in thousands) | | | | |
| Operating Data | | | | | |
| Adjusted EBITDA(4) | \$26,502 | \$22,620 | \$18,160 | \$13,774 | \$ 8,997 |
| Non-GAAP income per diluted share(5) | \$ 1.01 | \$ 0.84 | \$ 0.65 | \$ 0.53 | \$ 0.41 |
| Recurring revenue customers(6) | 24,805 | 23,410 | 21,983 | 19,690 | 17,977 |

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- (1) Includes stock-based compensation expense as follows (in thousands):

| | Year Ended December 31, | | | | |
|----------------------------|-------------------------|----------------|----------------|----------------|----------------|
| | 2016 | 2015 | 2014 | 2013 | 2012 |
| Cost of revenues | \$1,309 | \$ 989 | \$ 614 | \$ 475 | \$ 382 |
| Sales and marketing | 2,412 | 1,978 | 1,933 | 1,481 | 895 |
| Research and development | 618 | 640 | 444 | 266 | 140 |
| General and administrative | 3,684 | 2,772 | 2,405 | 1,981 | 1,338 |
| Total | <u>\$8,023</u> | <u>\$6,379</u> | <u>\$5,396</u> | <u>\$4,203</u> | <u>\$2,755</u> |

- (2) For 2013, amortization of intangible assets included \$290,000 for the impairment of a certain non-competition agreement.
- (3) For 2014, other expense included \$338,000 for a one-time Australian stamp duty tax related to the Leadtec acquisition.
- (4) Adjusted EBITDA consists of net income plus depreciation and amortization, interest expense, interest income, income tax expense (benefit), stock-based compensation expense and other adjustments as necessary for a fair presentation. Other adjustments included the impact of the fair value adjustment for the Toolbox Solutions share-based earn-out liability in 2016, a one-time Australian stamp duty tax related to the Leadtec acquisition in 2014, as well as the impact of use tax refunds in 2015, 2014 and 2013 related to items previously expensed. We use Adjusted EBITDA as a measure of operating performance because it assists us in comparing performance on a consistent basis, as it removes the impact of our capital structure from our operating results. We believe Adjusted EBITDA is useful to an investor in evaluating our operating performance because it is widely used to measure a company's operating performance without regard to items such as depreciation and amortization, which can vary depending upon accounting methods and the book value of assets, and to present a meaningful measure of corporate performance exclusive of our capital structure and the method by which assets were acquired. The following table provides a reconciliation of net income to Adjusted EBITDA (in thousands):

| | Year Ended December 31, | | | | |
|----------------------------------|-------------------------|-----------------|-----------------|-----------------|----------------|
| | 2016 | 2015 | 2014 | 2013 | 2012 |
| Net income | \$ 5,710 | \$ 4,639 | \$ 2,704 | \$ 1,051 | \$1,222 |
| Depreciation and amortization | 11,336 | 9,572 | 8,570 | 8,051 | 4,918 |
| Interest income, net | (601) | (197) | (187) | (112) | (19) |
| Income tax expense | 3,140 | 2,436 | 1,408 | 686 | 121 |
| Other | (1,106) | (209) | 269 | (105) | — |
| EBITDA | 18,479 | 16,241 | 12,764 | 9,571 | 6,242 |
| Stock-based compensation expense | 8,023 | 6,379 | 5,396 | 4,203 | 2,755 |
| Adjusted EBITDA | <u>\$26,502</u> | <u>\$22,620</u> | <u>\$18,160</u> | <u>\$13,774</u> | <u>\$8,997</u> |

- (5) Non-GAAP income per share consists of net income plus stock-based compensation expense and amortization expense related to intangible assets minus for 2016 the impact of the fair value adjustment for the Toolbox Solutions share-based earn-out liability divided by the weighted average number of shares of common stock outstanding during each period.

Compliance and Disclosure Interpretations published by the SEC in May 2016 (the "May C&DI") related to the use of non-GAAP financial measures discusses companies including an additional adjustment to non-GAAP income to reflect the income tax effects of the adjustments to GAAP net income, as discussed above. In reporting the non-GAAP income results below, we have elected to calculate non-GAAP income consistent with its historical practice, without the tax adjustment discussed in the May C&DI. We believe

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that maintaining consistency with our historical practice better allows investors to evaluate our financial performance. Commencing with the first quarter of 2017, we will begin tax effecting non-GAAP net income to conform its disclosure in accordance with the May C&DI.

We believe non-GAAP income per share is useful to an investor because it is widely used to measure a company's operating performance. The following table provides a reconciliation of net income to non-GAAP income per share (in thousands, except per share amounts):

| | Year Ended December 31, | | | | |
|--|-------------------------|-----------------|-----------------|-----------------|-----------------|
| | 2016 | 2015 | 2014 | 2013 | 2012 |
| Net income | \$ 5,710 | \$ 4,639 | \$ 2,704 | \$ 1,051 | \$ 1,222 |
| Stock-based compensation expense | 8,023 | 6,379 | 5,396 | 4,203 | 2,755 |
| Amortization of intangible assets | 4,738 | 3,307 | 2,856 | 3,158 | 1,767 |
| Other | (1,106) | — | — | — | — |
| Non-GAAP income | <u>\$17,365</u> | <u>\$14,325</u> | <u>\$10,956</u> | <u>\$ 8,412</u> | <u>\$ 5,744</u> |
| Non-GAAP income per share | | | | | |
| Basic | \$ 1.02 | \$ 0.86 | \$ 0.67 | \$ 0.55 | \$ 0.44 |
| Diluted | \$ 1.01 | \$ 0.84 | \$ 0.65 | \$ 0.53 | \$ 0.41 |
| Shares used to compute non-GAAP income per share | | | | | |
| Basic | 16,947 | 16,565 | 16,236 | 15,201 | 13,056 |
| Diluted | 17,241 | 17,032 | 16,814 | 15,931 | 13,910 |

- (6) This reflects the number of recurring revenue customers at the end of the period. Recurring revenue customers are customers with contracts to pay us monthly fees. A small portion of our recurring revenue customers consists of separate units within a larger organization. We treat each of these units, which may include divisions, departments, affiliates and franchises, as distinct customers. Our contracts with our recurring revenue customers typically allow the customer to cancel the contract for any reason with 30 to 90 days' notice.

Item 7. Management’s Discussion and Analysis of Financial Condition and Results of Operations

The following discussion and analysis of our financial condition and results of operations should be read together with the section titled “Selected Financial Data” and our audited financial statements and related notes which are included elsewhere in this Annual Report on Form 10-K. Our actual results could differ materially from those anticipated in the forward-looking statements included in this discussion as a result of certain factors, including, but not limited to, those discussed in “Risk Factors” included elsewhere in this Annual Report on Form 10-K.

Overview

We are a leading provider of cloud-based supply chain management solutions, providing network-proven fulfillment, sourcing, and item assortment management solutions, along with comprehensive retail performance analytics to thousands of customers worldwide. We provide our solutions through the SPS Commerce platform, a cloud-based product suite that improves the way suppliers, retailers, distributors and logistics firms orchestrate the sourcing, set up of new vendors and items, and fulfillment of the products that customers buy from retailers and suppliers. We derive the majority of our revenues from thousands of monthly recurring subscriptions from businesses that utilize our solutions.

We plan to continue to grow our business by further penetrating the supply chain management market, increasing revenues from our customers as their businesses grow, expanding our distribution channels, expanding our international presence and, from time to time, developing new solutions and applications. We also intend to selectively pursue acquisitions that will add customers, allow us to expand into new regions or allow us to offer new functionalities.

For 2016, 2015 and 2014, we generated revenues of \$193.3 million, \$158.5 million, and \$127.9 million, respectively. Our fiscal quarter ended December 31, 2016 represented our 64th consecutive quarter of increased revenues. Recurring revenues from recurring revenue customers accounted for 91.6%, 90.8%, and 90.0% of our total revenues for 2016, 2015, and 2014, respectively. Our revenues are not concentrated with any customer, as our largest customer represented 2% or less of total revenues in 2016, 2015, and 2014.

Key Financial Terms and Metrics

Sources of Revenues

Trading Partner Fulfillment. Our Fulfillment solution provides fulfillment automation and replaces or augments an organization’s existing trading partner electronic communication infrastructure, enabling suppliers to have visibility into the journey of an order and comply with retailers’ rule books and enabling the electronic exchange of information among numerous trading partners through various protocols.

Trading Partner Analytics. Our Analytics solution consists of data analytics applications that enable our customers to improve their visibility across, and analysis of, their supply chains. When focused on point-of-sale data, for example, retailers and suppliers can ensure inventory is located where demand is highest. Retailers improve their visibility into supplier performance and their understanding of product sell-through.

Trading Partner Assortment. Today’s retail marketplace requires the management of tens and even hundreds of individual attributes associated with each item a retailer or supplier sells today. This information can include digital images/video, customer facing descriptions and measurements, and warehouse information. Our Assortment product provides robust, extensible management of this information, enabling accurate orders and rapid fulfillment.

Trading Partner Sourcing. Through Retail Universe, our social network for the retail industry, retailers can source providers of new items, suppliers can connect with new retailers, and the broader retailing community can make connections to expand their business networks and grow.

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Trading Partner Community Development. Our Community Development solution provides communication programs based on our best practices. These programs enable organizations, from large and small retailers and suppliers to emerging providers of value-added products and services, to establish trading partner relationships with new trading partners to expand their businesses.

Other Trading Partner Solutions. We provide a number of peripheral solutions such as barcode labeling, planogram services and our scan and pack application, which helps trading partners process information to streamline the picking and packaging process.

Cost of Revenues and Operating Expenses

Cost of Revenues. Cost of revenues consist primarily of personnel costs for our customer success and implementation teams, customer support personnel and application support personnel. Cost of revenues also includes our cost of network services, which is primarily data center costs for the locations where we keep the equipment that serves our customers, and connectivity costs that facilitate electronic data transmission between our customers and their trading partners.

Sales and Marketing Expenses. Sales and marketing expenses consist primarily of personnel costs for our sales, marketing and product management teams, commissions earned by our sales personnel and marketing costs. In order to expand our business, we will continue to add resources to our sales and marketing efforts over time.

Research and Development Expenses. Research and development expenses consist primarily of personnel costs for development of new and maintenance of existing solutions. Our research and development group is also responsible for enhancing existing solutions and applications as well as internal tools and developing new information maps that integrate our customers to their trading partners in compliance with those trading partners' requirements.

General and Administrative Expenses. General and administrative expenses consist primarily of personnel costs for finance, human resources and internal information technology support, as well as legal, accounting and other fees, such as credit card processing fees.

Overhead Allocation. We allocate overhead expenses such as rent, certain employee benefit costs, office supplies and depreciation of general office assets to cost of revenues and operating expenses categories based on headcount.

Other Metrics

Recurring Revenue Customers. As of December 31, 2016, we had approximately 25,000 customers with contracts to pay us monthly fees, which we refer to as recurring revenue customers. We report recurring revenue customers at the end of a period. A small portion of our recurring revenue customers consist of separate units within a larger organization. We treat each of these units, which may include divisions, departments, affiliates and franchises, as distinct customers.

Average Recurring Revenues Per Recurring Revenue Customer. We calculate average recurring revenues per recurring revenue customer, which we also refer to as wallet share, by dividing the recurring revenues from recurring revenue customers for the period by the average of the beginning and ending number of recurring revenue customers for the period. For interim periods, we annualize this number by multiplying the quotient calculated above by the quotient of 12 divided by the number of months in the period. We anticipate that average recurring revenues per recurring revenue customer will continue to increase as we increase the number of solutions we offer and increase the penetration of those solutions across our customer base.

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Non-GAAP Financial Measures. To supplement our financial statements, we also provide investors with Adjusted EBITDA and non-GAAP income per share, both of which are non-GAAP financial measures. We believe that these non-GAAP measures provide useful information to management and investors regarding certain financial and business trends relating to our financial condition and results of operations. Our management uses these non-GAAP measures to compare the company's performance to that of prior periods for trend analyses and planning purposes. Adjusted EBITDA is also used for purposes of determining executive and senior management incentive compensation. These measures are also presented to our board of directors.

These non-GAAP measures should not be considered a substitute for, or superior to, financial measures calculated in accordance with generally accepted accounting principles in the United States of America. These non-GAAP financial measures exclude significant expenses and income that are required by GAAP to be recorded in the company's financial statements and are subject to inherent limitations. Investors should review the reconciliations of non-GAAP financial measures to the comparable GAAP financial measures that are included in this "Management's Discussion and Analysis of Financial Condition and Results of Operations."

Critical Accounting Policies and Estimates

The discussion of our financial condition and results of operations is based upon our financial statements, which are prepared in accordance with accounting principles generally accepted in the United States of America, or GAAP. The preparation of these financial statements requires us to make estimates, judgments and assumptions that affect the reported amounts of assets, liabilities, revenues, costs and expenses and related disclosures. On an ongoing basis, we evaluate our estimates and assumptions. We base our estimates of the carrying value of certain assets and liabilities on historical experience and on various other assumptions that we believe to be reasonable. Our actual results may differ from these estimates under different assumptions or conditions.

We believe that of our significant accounting policies, which are described in the notes to our financial statements, the following accounting policies involve a greater degree of judgment and complexity and are material to our financial statement presentation. A critical accounting policy is one that is both material to the presentation of our financial statements and requires us to make difficult, subjective or complex judgments for uncertain matters that could have a material effect on our financial condition and results of operations. Accordingly, these are the policies we believe are the most critical to aid in fully understanding and evaluating our financial condition and results of operations.

Revenue Recognition

We generate revenues by providing a number of solutions to our customers. These solutions include Trading Partner Fulfillment, Trading Partner Enablement and Trading Partner Analytics. Our cloud-based solutions allow our customers to meet their supply chain management requirements.

Fees related to our Trading Partner Fulfillment and Trading Partner Analytics solutions consist of two revenue sources: set-up fees and recurring monthly fees. Set-up fees are specific for each connection a customer has with a trading partner and most of our customers have connections with numerous trading partners. Set-up fees are nonrefundable upfront fees that do not have standalone value to our customer and are not separable from the recurring monthly fees. All set-up fees and related costs are deferred and recognized ratably over the average life of the connection between the customer and the trading partner, which is approximately two years. We begin recognizing set-up fee revenue once the connection is established. Set-up fees for which connections have not yet been established are classified as long-term. We continue to evaluate the length of the amortization period as more experience is gained with cancellations and technology changes requested by our customers. It is possible that, in the future, the period over which such subscription set-up fees and costs are amortized may be adjusted. Any change in our estimate of the average connection life will affect our future results of operations.

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Allowance for Doubtful Accounts

We maintain an allowance for doubtful accounts for estimated losses resulting from our customers' inability to pay us. The provision is based on the overall composition of our accounts receivable aging, our prior history of accounts receivable write-offs, and the type of customers and our experience with specific customers. In order to identify these customers, we perform ongoing reviews of all customers that have breached their payment terms, as well as those that have filed for bankruptcy or for whom information has become available indicating a significant risk of non-recoverability. In addition, we have experienced significant growth in the number of our customers, and we have less payment history to rely upon with these customers. We rely on historical trends of bad debt as a percentage of total accounts receivable and apply these percentages to the accounts receivable associated with new customers and evaluate these customers over time. To the extent that our future collections differ from our assumptions based on historical experience, the amount of our bad debt and allowance recorded may be different.

Income Taxes

We account for income taxes using the liability method, which requires recognition of deferred tax assets and liabilities for the expected future tax consequences of events that have been included in the financial statements. Under this method, deferred tax assets and liabilities are determined based on the difference between the financial statement and tax basis of assets and liabilities using enacted tax rates in effect for the year in which the differences are expected to reverse. Deferred tax assets are reduced by a valuation allowance when it is not "more likely than not" that the deferred tax asset will be utilized.

We assess our ability to realize our deferred tax assets at the end of each reporting period. Realization of our deferred tax assets is contingent upon future taxable earnings. Accordingly, this assessment requires significant estimates and judgment. If the estimates of future taxable income vary from actual results, our assessment regarding the realization of these deferred tax assets could change. Future changes in the estimated amount of deferred taxes expected to be realized will be reflected in our consolidated financial statements in the period the estimate is changed, with a corresponding adjustment to our operating results.

We recognize the financial statement benefit of a tax position only after determining that the relevant tax authority would "more likely than not" sustain the position following an audit. For tax positions meeting the "more likely than not" threshold, the amount recognized in the financial statements is the largest benefit that has a greater than 50% likelihood of being realized upon ultimate settlement with the relevant tax authority.

We elected to early adopt Accounting Standards Update (ASU) No. 2015-17, *Balance Sheet Classification of Deferred Taxes*, which requires deferred tax assets and liabilities to be classified as noncurrent on the classified statement of financial position. We adopted this updated accounting standard prospectively to simplify the presentation of our deferred tax assets and liabilities.

Valuation of Goodwill and Purchased Intangible Assets

Goodwill represents the excess of the purchase price over the fair value of identifiable net assets acquired in a business combination. Assets acquired may include identifiable intangible assets, such as subscriber relationships, which are recognized separately from goodwill.

We test goodwill for impairment annually, at November 30, or more frequently if events or changes in circumstances indicate that the asset might be impaired. The impairment test is conducted by comparing the fair value of the net assets with the carrying value of the reporting unit. Fair value is determined using the direct market observation of market price and outstanding equity of the reporting unit at November 30. If the carrying value were to exceed the fair value of the reporting unit, the goodwill may be impaired. If this were to occur, the fair value would then be allocated to assets and liabilities in a manner similar to a purchase price allocation in order to determine the implied fair value of the goodwill. This implied fair value would then be compared to the carrying amount of the goodwill and, if it were less, an impairment loss would be recognized.

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During 2016, we changed our annual impairment testing date from December 31 to November 30. This voluntary change in accounting principle, applied prospectively, is preferable as it allows more timely completion of our annual impairment test and does not delay, accelerate, or avoid an impairment charge.

Results of Operations

Year Ended December 31, 2016 Compared to Year Ended December 31, 2015

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

| | Year Ended December 31, | | | | Change | |
|-----------------------------------|-------------------------|--------------|-----------------|--------------|----------|---------|
| | 2016 | % of revenue | 2015 | % of revenue | | % |
| Revenues | \$193,295 | 100.0% | \$158,518 | 100.0% | \$34,777 | 21.9% |
| Cost of revenues | 64,346 | 33.3 | 50,043 | 31.6 | 14,303 | 28.6 |
| Gross profit | <u>128,949</u> | 66.7 | <u>108,475</u> | 68.4 | 20,474 | 18.9 |
| Operating expenses | | | | | | |
| Sales and marketing | 65,886 | 34.1 | 55,374 | 34.9 | 10,512 | 19.0 |
| Research and development | 21,981 | 11.4 | 17,954 | 11.3 | 4,027 | 22.4 |
| General and administrative | 28,827 | 14.9 | 24,817 | 15.7 | 4,010 | 16.2 |
| Amortization of intangible assets | 4,738 | 2.5 | 3,307 | 2.1 | 1,431 | 43.3 |
| Total operating expenses | <u>121,432</u> | 62.8 | <u>101,452</u> | 64.0 | 19,980 | 19.7 |
| Income from operations | 7,517 | 3.9 | 7,023 | 4.4 | 494 | 7.0 |
| Other income (expense) | | | | | | |
| Interest income, net | 601 | 0.3 | 197 | 0.1 | 404 | 205.1 |
| Other income (expense), net | 732 | 0.4 | (145) | (0.1) | 877 | (604.8) |
| Total other income, net | <u>1,333</u> | 0.7 | <u>52</u> | — | 1,281 | 2,463.5 |
| Income before income taxes | 8,850 | 4.6 | 7,075 | 4.5 | 1,775 | 25.1 |
| Income tax expense | <u>(3,140)</u> | (1.6) | <u>(2,436)</u> | (1.5) | (704) | 28.9 |
| Net income | <u>\$ 5,710</u> | 3.0% | <u>\$ 4,639</u> | 2.9% | 1,071 | 23.1% |

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

Revenues. Revenues for 2016 increased \$34.8 million, or 22%, to \$193.3 million from \$158.5 million for 2015. The increase in revenues resulted from two primary factors: the increase in recurring revenue customers and the increase in average recurring revenues per recurring revenue customer, which we also refer to as wallet share.

- The number of recurring revenue customers increased 6% to 24,805 at December 31, 2016 from 23,410 at December 31, 2015.
- Average recurring revenues per recurring revenue customer, or wallet share, increased 16% to \$7,344 for 2016 from \$6,343 for 2015. This increase in wallet share was primarily attributable to increased fees resulting from increased usage of our solutions by our recurring revenue customers and growth in larger customers.

Recurring revenues from recurring revenue customers increased 23% in 2016, as compared to 2015, and accounted for 92% of our total revenues for 2016 and 91% for 2015. We anticipate that the number of recurring revenue customers and wallet share will continue to increase as we increase the number of solutions we offer and increase the penetration of those solutions across our customer base.

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Cost of Revenues. Cost of revenues for 2016 increased \$14.3 million, or 29%, to \$64.3 million from \$50.0 million for 2015. This increase was primarily due to increased headcount in 2016 which resulted in higher personnel-related costs of approximately \$10.0 million, occupancy costs of approximately \$800,000 and stock based compensation expense of \$321,000. We also incurred higher expenses for software and cloud-based subscriptions of \$2.2 million and depreciation expense of \$627,000 for continued investment in the infrastructure supporting our solutions in 2016 as compared to 2015. As a percentage of revenues, cost of revenues was 33% for 2016 compared to 32% for 2015. Going forward, we anticipate that cost of revenues will increase in absolute dollars as we continue to expand our business.

Sales and Marketing Expenses. Sales and marketing expenses for 2016 increased \$10.5 million, or 19%, to \$65.9 million from \$55.4 million for 2015. This increase was primarily due to increased headcount in 2016, which resulted in higher personnel-related costs of \$8.1 million and stock based compensation expense of \$434,000, and increased commissions of approximately \$2.0 million earned by sales personnel and referral partners from generating new business. As a percentage of revenues, sales and marketing expenses were 34% for 2016 compared to 35% for 2015. As we expand our business, we will continue to add resources to our sales and marketing efforts over time, and we expect that these expenses will continue to increase in absolute dollars.

Research and Development Expenses. Research and development expenses for 2016 increased \$4.0 million, or 22%, to \$22.0 million from \$18.0 million for 2015. This increase was primarily due to increased headcount in 2016 which resulted in higher personnel-related costs of \$3.5 million. We also incurred higher expenses for software and cloud-based subscriptions of \$428,000 in 2016 as compared to 2015. As a percentage of revenues, research and development expenses were 11% for both 2016 and 2015, respectively. As we enhance and expand our solutions and applications, we expect that research and development expenses will continue to increase in absolute dollars.

General and Administrative Expenses. General and administrative expenses for 2016 increased \$4.0 million, or 16%, to \$28.8 million from \$24.8 million for 2015. This increase was primarily due to increased headcount in 2016 which resulted in higher personnel-related costs of \$1.4 million and stock based compensation expense of \$911,000. We also incurred higher expenses for software subscription and maintenance of \$965,000. We also had increases in our provision for doubtful accounts, credit card fees, and legal fees offset by lower charitable contributions in 2016 as compared to 2015. As a percentage of revenues, general and administrative expenses were 15% and 16% for 2016 and 2015, respectively. Going forward, we expect that general and administrative expenses will continue to increase in absolute dollars as we expand our business.

Amortization of Intangible Assets. Amortization of intangible assets for 2016 increased \$1.4 million from 2015. This increase was due to the impact of amortization from the intangible assets acquired in the Toolbox Solutions acquisition in January 2016.

Other Income. Other income for 2016 included \$1.0 million for an adjustment of the Toolbox Solutions share-based earn-out liability due to the fact that the contingency was resolved with no consideration paid.

Income Tax Expense. Our 2016 and 2015 provision for income taxes was \$3.1 million and \$2.4 million, respectively, and included current federal, state and foreign income taxes as well as deferred federal and state income taxes. The increase in income tax expense in 2016 was primarily due to the increase in pretax book income of \$1.8 million.

See Note J to our consolidated financial statements, included in this Annual Report on Form 10-K, for additional information regarding our income taxes.

Adjusted EBITDA. Adjusted EBITDA, which is a non-GAAP measure of financial performance, consists of net income plus depreciation and amortization, interest expense, interest income, income tax expense, stock-based compensation expense and other adjustments as necessary for a fair presentation. Other adjustments

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included the impact of an earn-out adjustment related to the Toolbox acquisition in 2016, as well as the impact of use tax refunds in 2015 related to items previously expensed. The following table provides a reconciliation of net income to Adjusted EBITDA (in thousands):

| | Year Ended December 31, | |
|----------------------------------|----------------------------|-----------------|
| | 2016 | 2015 |
| Net income | \$ 5,710 | \$ 4,639 |
| Depreciation and amortization | 11,336 | 9,572 |
| Interest income, net | (601) | (197) |
| Income tax expense | 3,140 | 2,436 |
| Other | (1,106) | (209) |
| EBITDA | 18,479 | 16,241 |
| Stock-based compensation expense | 8,023 | 6,379 |
| Adjusted EBITDA | <u>\$26,502</u> | <u>\$22,620</u> |

Non-GAAP Income per Share. Non-GAAP income per share, which is also a non-GAAP measure of financial performance, consists of net income plus stock-based compensation expense and amortization expense related to intangible assets, less the impact of the 2016 fair value adjustment for the Toolbox Solutions share-based earn-out liability, divided by the weighted average number of shares of common stock outstanding during each period.

Compliance and Disclosure Interpretations published by the SEC in May 2016 (the “May C&DI”) related to the use of non-GAAP financial measures discusses companies including an additional adjustment to non-GAAP income to reflect the income tax effects of the adjustments to GAAP net income, as discussed above. In reporting the non-GAAP income results below, we have elected to calculate non-GAAP income consistent with its historical practice, without the tax adjustment discussed in the May C&DI. We believe that maintaining consistency with our historical practice better allows investors to evaluate our financial performance. Commencing with the first quarter of 2017, we will begin tax effecting non-GAAP net income to conform its disclosure in accordance with the May C&DI.

The following table provides a reconciliation of net income to non-GAAP income per share (in thousands, except per share amounts):

| | Year Ended December 31, | |
|--|----------------------------|-----------------|
| | 2016 | 2015 |
| Net income | \$ 5,710 | \$ 4,639 |
| Stock-based compensation expense | 8,023 | 6,379 |
| Amortization of intangible assets | 4,738 | 3,307 |
| Other | (1,106) | — |
| Non-GAAP income | <u>\$17,365</u> | <u>\$14,325</u> |
| Non-GAAP income per share | | |
| Basic | \$ 1.02 | \$ 0.86 |
| Diluted | \$ 1.01 | \$ 0.84 |
| Shares used to compute non-GAAP income per share | | |
| Basic | 16,947 | 16,565 |
| Diluted | 17,241 | 17,032 |

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Year Ended December 31, 2015 Compared to Year Ended December 31, 2014

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

| | Year Ended December 31, | | Year Ended December 31, | | Change | |
|-----------------------------------|-------------------------|--------------|-------------------------|--------------|----------|---------|
| | 2015 | % of revenue | 2014 | % of revenue | | % |
| Revenues | \$158,518 | 100.0% | \$127,947 | 100.0% | \$30,571 | 23.9% |
| Cost of revenues | 50,043 | 31.6 | 39,991 | 31.3 | 10,052 | 25.1 |
| Gross profit | 108,475 | 68.4 | 87,956 | 68.7 | 20,519 | 23.3 |
| Operating expenses | | | | | | |
| Sales and marketing | 55,374 | 34.9 | 46,990 | 36.7 | 8,384 | 17.8 |
| Research and development | 17,954 | 11.3 | 13,494 | 10.5 | 4,460 | 33.1 |
| General and administrative | 24,817 | 15.7 | 20,233 | 15.8 | 4,584 | 22.7 |
| Amortization of intangible assets | 3,307 | 2.1 | 2,856 | 2.2 | 451 | 15.8 |
| Total operating expenses | 101,452 | 64.0 | 83,573 | 65.3 | 17,879 | 21.4 |
| Income from operations | 7,023 | 4.4 | 4,383 | 3.4 | 2,640 | 60.2 |
| Other income (expense) | | | | | | |
| Interest income, net | 197 | 0.1 | 187 | 0.1 | 10 | 5.3 |
| Other expense | (145) | (0.1) | (458) | (0.4) | 313 | (68.3) |
| Total other income (expense), net | 52 | — | (271) | (0.2) | 323 | (119.2) |
| Income before income taxes | 7,075 | 4.5 | 4,112 | 3.2 | 2,963 | 72.1 |
| Income tax expense | (2,436) | (1.5) | (1,408) | (1.1) | (1,028) | 73.0 |
| Net income | \$ 4,639 | 2.9% | \$ 2,704 | 2.1 | 1,935 | 71.6 |

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

Revenues. Revenues for 2015 increased \$30.6 million, or 24%, to \$158.5 million from \$127.9 million for 2014. The increase in revenues resulted from two primary factors: the increase in recurring revenue customers and the increase in average recurring revenues per recurring revenue customer, which we also refer to as wallet share.

- The number of recurring revenue customers increased 6% to 23,410 at December 31, 2015 from 21,983 at December 31, 2014.
- Average recurring revenues per recurring revenue customer, or wallet share, increased 15% to \$6,343 for 2015 from \$5,524 for 2014. This increase in wallet share was primarily attributable to increased fees resulting from increased usage of our solutions by our recurring revenue customers and growth in larger customers.

Recurring revenues from recurring revenue customers increased 25% in 2015, as compared to 2014, and accounted for 91% of our total revenues for 2015 and 90% for 2014. We anticipate that the number of recurring revenue customers and wallet share will continue to increase as we increase the number of solutions we offer and increase the penetration of those solutions across our customer base.

Cost of Revenues. Cost of revenues for 2015 increased \$10.1 million, or 25%, to \$50.0 million from \$40.0 million for 2014. This increase was primarily due to increased headcount in 2015 which resulted in higher personnel-related costs of approximately \$7.2 million, occupancy costs of approximately \$516,000 and stock based compensation expense of \$375,000. We also incurred higher expenses for software and cloud-based subscriptions of \$988,000 and depreciation expense of \$482,000 for continued investment in the infrastructure supporting our solutions in 2015 as compared to 2014. As a percentage of revenues, cost of revenues was 32% for 2015 compared to 31% for 2014.

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Sales and Marketing Expenses. Sales and marketing expenses for 2015 increased \$8.4 million, or 18%, to \$55.4 million from \$47.0 million for 2014. This increase was primarily due to increased headcount in 2015, which resulted in higher personnel-related costs of \$6.2 million and occupancy costs of \$409,000, and increased commissions of approximately \$1.7 million earned by sales personnel and referral partners from generating new business. As a percentage of revenues, sales and marketing expenses were 35% for 2015 compared to 37% for 2014.

Research and Development Expenses. Research and development expenses for 2015 increased \$4.5 million, or 33%, to \$18.0 million from \$13.5 million for 2014. This increase was primarily due to increased headcount in 2015 which resulted in higher personnel-related costs of \$3.7 million, occupancy costs of \$265,000 and stock based compensation expense of \$195,000. We also incurred higher expenses for software and cloud-based subscriptions of \$327,000 in 2015 as compared to 2014. As a percentage of revenues, research and development expenses were 11% for both 2015 and 2014.

General and Administrative Expenses. General and administrative expenses for 2015 increased \$4.6 million, or 23%, to \$24.8 million from \$20.2 million for 2014. This increase was primarily due to increased headcount in 2015 which resulted in higher personnel-related costs of \$2.7 million, occupancy costs of \$423,000 and stock based compensation expense of \$368,000. We also incurred higher expenses for software subscription and maintenance of \$286,000. We also had increases in our provision for doubtful accounts, credit card fees and charitable contributions offset by lower legal fees in 2015 as compared to 2014. As a percentage of revenues, general and administrative expenses were 16% for both 2015 and 2014.

Amortization of Intangible Assets. Amortization of intangible assets for 2015 increased \$451,000 from 2014. This increase was due to the impact of a full year of amortization from the intangible assets acquired in the Leadtec acquisition in October 2014.

Other Expense. Other expense for 2014 included \$338,000 for a one-time Australian stamp duty tax related to the Leadtec acquisition in October 2014.

Income Tax Expense. Our 2015 and 2014 provision for income taxes was \$2.4 million and \$1.4 million, respectively, and included current federal, state and foreign income taxes as well as deferred federal and state income taxes. The increase in income tax expense in 2015 was primarily due to the increase in pretax book income of \$3.0 million.

See Note J to our consolidated financial statements, included in this Annual Report on Form 10-K, for additional information regarding our income taxes.

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Adjusted EBITDA. Adjusted EBITDA, which is a non-GAAP measure of financial performance, consists of net income plus depreciation and amortization, interest expense, interest income, income tax expense, stock-based compensation expense and other adjustments as necessary for a fair presentation. Other adjustments included the impact of a one-time Australian stamp duty tax related to the Leadtec acquisition in 2014, as well as the impact of use tax refunds in 2015 and 2014 related to items previously expensed. The following table provides a reconciliation of net income to Adjusted EBITDA (in thousands):

| | Year Ended December 31, | |
|----------------------------------|----------------------------|-----------------|
| | 2015 | 2014 |
| Net income | \$ 4,639 | \$ 2,704 |
| Depreciation and amortization | 9,572 | 8,570 |
| Interest income, net | (197) | (187) |
| Income tax expense | 2,436 | 1,408 |
| Other | (209) | 269 |
| EBITDA | 16,241 | 12,764 |
| Stock-based compensation expense | 6,379 | 5,396 |
| Adjusted EBITDA | <u>\$22,620</u> | <u>\$18,160</u> |

Non-GAAP Income per Share. Non-GAAP income per share, which is also a non-GAAP measure of financial performance, consists of net income plus stock-based compensation expense and amortization expense related to intangible assets divided by the weighted average number of shares of common stock outstanding during each period. The following table provides a reconciliation of net income to non-GAAP income per share (in thousands, except per share amounts):

| | Year Ended December 31, | |
|--|----------------------------|-----------------|
| | 2015 | 2014 |
| Net income | \$ 4,639 | \$ 2,704 |
| Stock-based compensation expense | 6,379 | 5,396 |
| Amortization of intangible assets | 3,307 | 2,856 |
| Non-GAAP income | <u>\$14,325</u> | <u>\$10,956</u> |
| Non-GAAP income per share | | |
| Basic | \$ 0.86 | \$ 0.67 |
| Diluted | \$ 0.84 | \$ 0.65 |
| Shares used to compute non-GAAP income per share | | |
| Basic | 16,565 | 16,236 |
| Diluted | 17,032 | 16,814 |

Liquidity and Capital Resources

At December 31, 2016, our principal sources of liquidity were cash, cash equivalents and marketable securities totaling \$146.4 million and accounts receivable, net of allowance for doubtful accounts of \$20.7 million compared to cash, cash equivalents and marketable securities totaling \$144.0 million and accounts receivable, net of allowance for doubtful accounts of \$17.6 million at December 31, 2015. Marketable securities are invested in accordance with our investment policy, with a goal of maintaining liquidity and capital preservation. Our cash equivalents and marketable securities are held in highly liquid money market funds, commercial paper, federal agency securities and corporate debt securities.

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Net Cash Flows from Operating Activities

Net cash provided by operating activities was \$18.8 million for 2016 compared to \$14.4 million for 2015. The increase in operating cash flows as compared to 2015 was driven by a \$1.1 million increase in net income, a \$0.8 million increase in non-cash expenses and a \$2.5 million increase primarily due to increases in deferred revenues, accrued expenses and accounts payable, partially offset by increases in deferred costs and deferred rent as compared to 2015.

Net cash provided by operating activities was \$14.4 million for 2015 compared to \$16.8 million for 2014. The decrease in operating cash flows as compared to 2014 was driven by the decrease in accounts payable and accrued expenses due to the timing of payments and the Leadtec acquisition in the fourth quarter of 2014 along with the decrease in other current and non-current assets also due to the timing of payments, which was somewhat offset by higher net income and the increase in non-cash expenses.

Net Cash Flows from Investing Activities

Net cash used in investing activities was \$34.1 million for 2016 compared to \$31.3 million for 2015. The increase in cash used in investing activities as compared to 2015 was driven by the \$18.0 million acquisition of Toolbox Solutions, net of cash acquired, partially offset by \$15.0 million provided by maturities of marketable securities. There was no significant change in the amount of cash used for purchases of marketable securities or capital expenditures in 2016 compared to 2015. In general, our capital expenditures are for supporting our business growth and existing customer base, as well as for our internal use such as equipment for our employees.

Net cash used in investing activities was \$31.3 million for 2015 compared to \$20.2 million for 2014. The increase in cash used in investing activities as compared to 2014 was driven by \$22.5 million in purchases of marketable securities and a \$1.1 million increase in capital expenditures, partially offset by the fact that there were no business acquired in 2015, while Leadtec was acquired for \$12.5 million in 2014.

Net Cash Flows from Financing Activities

Net cash provided by financing activities was \$10.1 million, \$8.3 million and \$3.5 million for 2016, 2015 and 2014, respectively, all related to the exercise of stock options and proceeds from our employee stock purchase plan.

Adequacy of Capital Resources

Our future capital requirements may vary significantly from those now planned and will depend on many factors, including:

- costs to develop and implement new solutions and applications, if any;
- sales and marketing resources needed to further penetrate our market and gain acceptance of new solutions and applications that we may develop;
- expansion of our operations in the United States and internationally;
- response of competitors to our solutions and applications; and,
- use of capital for acquisitions, if any.

Historically, we have experienced increases in our expenditures consistent with the growth in our operations and personnel, and we anticipate that our expenditures will continue to increase as we expand our business.

We believe our cash, cash equivalents, marketable securities and cash flows from our operations will be sufficient to meet our working capital and capital expenditure requirements for at least the next twelve months.

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During the last three years, inflation and changing prices have not had a material effect on our business and we do not expect that inflation or changing prices will materially affect our business in the foreseeable future.

Off-Balance Sheet Arrangements

We do not have any off-balance sheet arrangements, investments in special purpose entities or undisclosed borrowings or debt. Additionally, we are not a party to any derivative contracts or synthetic leases.

Contractual and Commercial Commitment Summary

Our contractual obligations and commercial commitments as of December 31, 2016 are summarized below:

| Contractual Obligations | Payments Due By Period (in thousands) | | | | |
|-----------------------------|---------------------------------------|---------------------|-----------|-----------|----------------------|
| | Total | Less Than 1 Year | 1-3 Years | 3-5 Years | More Than 5 Years |
| Operating lease obligations | \$13,707 | \$ 3,318 | \$ 6,343 | \$ 2,872 | \$ 1,174 |

Seasonality

The size and breadth of our customer base mitigates the seasonality of any particular retailer. As a result, our results of operations are not materially affected by seasonality.

Recent Accounting Pronouncements

In May 2014, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update (“ASU”) No. 2014-09, *Revenue from Contracts with Customers (Topic 606)*, which requires an entity to recognize the amount of revenue to which it expects to be entitled for the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. This guidance will replace most existing revenue recognition guidance in GAAP when it becomes effective. These new requirements are effective for annual reporting periods beginning after December 15, 2017, and interim periods within those annual periods. We do not believe the new revenue recognition standard will materially impact our recognition of the primary fees received from customers for our cloud-based supply chain solutions. We believe the adoption of the new standard could impact our accounting for certain upfront set-up fees and the periods over which the related revenues are recognized, as well as the timing of cost recognition for sales commissions and other contract acquisition costs. We are currently evaluating implementation methods and the extent of the impact that implementation of this standard will have on our consolidated financial statements upon adoption.

In November 2015, the FASB issued ASU No. 2015-17, *Balance Sheet Classification of Deferred Taxes*, which amends the guidance requiring companies to separate deferred income tax liabilities and assets into current and non-current amounts in a classified statement of financial position. This accounting guidance simplifies the presentation of deferred income taxes, such that deferred tax liabilities and assets be classified as non-current in a classified statement of financial position. This accounting guidance is effective for us beginning in the first quarter of 2017, but we elected to early adopt this guidance prospectively as of December 31, 2015. As a result, we have classified all deferred tax liabilities and assets as non-current in the condensed consolidated balance sheet as of December 31, 2016 and December 31, 2015.

In February 2016, the FASB issued ASU 2016-02, *Leases*, which will supersede the existing lease guidance and will require all leases with a term greater than 12 months to be recognized in the statements of financial position and eliminate current real estate-specific lease guidance, while maintaining substantially similar classification criteria for distinguishing between finance leases and operating leases. This standard is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018, with early adoption permitted. We believe the adoption of the new lease accounting standard will materially impact our

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consolidated financial statements by increasing our non-current assets and non-current liabilities on our consolidated balance sheets in order to record the right of use assets and related lease liabilities for our existing operating leases. We are in the process of determining the financial statement impact and are currently unable to estimate the impact on our consolidated financial statements.

In March 2016, the FASB issued ASU 2016-09, *Improvements to Employee Share-Based Payment Accounting*, which permits entities to make an accounting policy election related to how forfeitures will impact the recognition of compensation cost for stock-based compensation, and also eliminates the requirement that excess tax benefits be realized as a reduction in current taxes payable before the associated tax benefit can be recognized as an increase in paid in capital. This standard is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2016, with early adoption permitted. We expect that our previously unrecognized federal and state net operating losses (\$46.2 million and \$10.7 million, respectively, as of December 31, 2016) will be included in the deferred tax assets recognized in our consolidated balance sheets on a modified retrospective basis as of January 1, 2017. With the adoption of ASU 2016-09 we will also be required to present excess tax benefits as an operating activity in the same manner as other cash flows related to income taxes on the statement of cash flows rather than as a financing activity.

Item 7A. Quantitative and Qualitative Disclosures About Market Risk

Interest Rate Sensitivity Risk. The principal objectives of our investment activities are to preserve principal, provide liquidity and maximize income consistent with minimizing risk of material loss. We are exposed to market risk related to changes in interest rates. However, based on the nature and current level of our investments (primarily cash and cash equivalents, which approximate fair value due to their short maturities, and marketable securities), we believe there is no material risk exposure. We do not enter into investments for trading or speculative purposes.

We did not have any outstanding debt as of December 31, 2016 and 2015. We therefore do not have any material risk to interest rate fluctuations.

Foreign Currency Exchange Risk. We have revenue, expenses, assets and liabilities that are denominated in currencies other than the U.S. dollar, primarily the Australian dollar and Canadian dollar. As of December 31, 2016, we maintained approximately 10% of our total cash and cash equivalents outside of the United States in foreign currencies, primarily in Australian and Canadian dollars. We believe that a significant change in foreign currency exchange rates or an inability to access these funds would not affect our ability to meet our operational needs. As we expand internationally, our results of operations and cash flows may be impacted by changes in foreign currency exchange rates, and would be adversely impacted when the U.S. dollar appreciates relative to other foreign currencies. We have not used any forward contracts or currency borrowings to hedge our exposure to foreign currency exchange risk, although we may do so in the future.

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Item 8. *Financial Statements and Supplementary Data*

SPS Commerce, Inc. Consolidated Financial Statements

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Report of Independent Registered Public Accounting Firm

The Board of Directors and Stockholders
SPS Commerce, Inc.:

We have audited the accompanying consolidated balance sheets of SPS Commerce, Inc. and subsidiaries as of December 31, 2016 and 2015, and the related consolidated statements of comprehensive income, stockholders' equity, and cash flows for each of the years in the three-year period ended December 31, 2016. We also have audited SPS Commerce, Inc.'s internal control over financial reporting as of December 31, 2016, based on criteria established in Internal Control — Integrated Framework (2013) issued by the Committee of Sponsoring Organizations of the Treadway Commission. SPS Commerce, Inc.'s management is responsible for these consolidated financial statements, for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Management's Annual Report on Internal Control Over Financial Reporting. Our responsibility is to express an opinion on these consolidated financial statements and an opinion on the Company's internal control over financial reporting based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement and whether effective internal control over financial reporting was maintained in all material respects. Our audits of the consolidated financial statements included examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audits also included performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

A company's internal control over financial reporting is a process designed 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. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of SPS Commerce, Inc. and subsidiaries as of December 31, 2016 and 2015, and the results of their operations and their cash flows for each of the years in the three-year period ending December 31, 2016, in conformity with U.S. generally accepted accounting principles. Also in our opinion, SPS Commerce, Inc. and subsidiaries maintained, in all material respects, effective internal control over financial reporting as of December 31, 2016, based on criteria established in Internal Control — Integrated Framework (2013) issued by the Committee of Sponsoring Organizations of the Treadway Commission .

SPS Commerce Canada, Ltd., a wholly-owned subsidiary of SPS Commerce, Inc., acquired all outstanding common shares of Toolbox Solutions, Inc. ("Toolbox") during the first quarter of 2016, and management excluded from its assessment of the effectiveness of internal control over financial reporting as of

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December 31, 2016, Toolbox's internal control over financial reporting associated with total assets of approximately four percent of SPS Commerce, Inc.'s total assets and four percent of revenues in the consolidated financial statements of SPS Commerce, Inc. as of and for the year ended December 31, 2016. Our audit of internal control over financial reporting of SPS Commerce, Inc. also excluded an evaluation of the internal control over financial reporting of Toolbox.

/s/ KPMG LLP

Minneapolis, Minnesota
February 27, 2017

SPS COMMERCE, INC.
CONSOLIDATED BALANCE SHEETS
(In thousands, except share amounts)

| | December 31, | |
|--|------------------|------------------|
| | 2016 | 2015 |
| ASSETS | | |
| CURRENT ASSETS | | |
| Cash and cash equivalents | \$115,877 | \$121,538 |
| Short-term marketable securities | 23,076 | 7,517 |
| Accounts receivable, net | 20,746 | 17,615 |
| Deferred costs | 19,224 | 15,086 |
| Other current assets | 7,010 | 5,030 |
| Total current assets | 185,933 | 166,786 |
| PROPERTY AND EQUIPMENT, net | 15,314 | 13,620 |
| GOODWILL | 49,777 | 33,848 |
| INTANGIBLE ASSETS, net | 19,788 | 15,081 |
| MARKETABLE SECURITIES, non-current | 7,494 | 14,950 |
| OTHER ASSETS | | |
| Deferred costs, non-current | 6,086 | 5,260 |
| Deferred income taxes, non-current | 12,446 | 11,149 |
| Other non-current assets | 1,527 | 1,037 |
| Total assets | <u>\$298,365</u> | <u>\$261,731</u> |
| LIABILITIES AND STOCKHOLDERS' EQUITY | | |
| CURRENT LIABILITIES | | |
| Accounts payable | \$ 2,302 | \$ 2,163 |
| Accrued compensation | 13,740 | 11,150 |
| Accrued expenses | 3,508 | 1,987 |
| Deferred revenue | 11,055 | 7,740 |
| Deferred rent | 1,556 | 1,194 |
| Total current liabilities | 32,161 | 24,234 |
| OTHER LIABILITIES | | |
| Deferred revenue, non-current | 10,847 | 11,005 |
| Deferred rent, non-current | 4,179 | 4,307 |
| Deferred income tax liability | 1,911 | — |
| Total liabilities | <u>49,098</u> | <u>39,546</u> |
| COMMITMENTS and CONTINGENCIES | | |
| STOCKHOLDERS' EQUITY | | |
| Preferred stock, \$0.001 par value; 5,000,000 shares authorized; 0 shares issued and outstanding | — | — |
| Common stock, \$0.001 par value; 55,000,000 shares authorized; 17,081,145 and 16,723,994 shares issued and outstanding, respectively | 17 | 17 |
| Additional paid-in capital | 286,315 | 265,265 |
| Accumulated deficit | (33,739) | (39,449) |
| Accumulated other comprehensive loss | (3,326) | (3,648) |
| Total stockholders' equity | <u>249,267</u> | <u>222,185</u> |
| Total liabilities and stockholders' equity | <u>\$298,365</u> | <u>\$261,731</u> |

See accompanying notes to these consolidated financial statements.

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SPS COMMERCE, INC.
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(In thousands, except per share amounts)

| | Year Ended December 31, | | |
|---|-------------------------|-----------|-----------|
| | 2016 | 2015 | 2014 |
| Revenues | \$193,295 | \$158,518 | \$127,947 |
| Cost of revenues | 64,346 | 50,043 | 39,991 |
| Gross profit | 128,949 | 108,475 | 87,956 |
| Operating expenses | | | |
| Sales and marketing | 65,886 | 55,374 | 46,990 |
| Research and development | 21,981 | 17,954 | 13,494 |
| General and administrative | 28,827 | 24,817 | 20,233 |
| Amortization of intangible assets | 4,738 | 3,307 | 2,856 |
| Total operating expenses | 121,432 | 101,452 | 83,573 |
| Income from operations | 7,517 | 7,023 | 4,383 |
| Other income (expense) | | | |
| Interest income, net | 601 | 197 | 187 |
| Other income (expense), net | 732 | (145) | (458) |
| Total other income (expense), net | 1,333 | 52 | (271) |
| Income before income taxes | 8,850 | 7,075 | 4,112 |
| Income tax expense | (3,140) | (2,436) | (1,408) |
| Net income | \$ 5,710 | \$ 4,639 | \$ 2,704 |
| Net income per share | | | |
| Basic | \$ 0.34 | \$ 0.28 | \$ 0.17 |
| Diluted | \$ 0.33 | \$ 0.27 | \$ 0.16 |
| Weighted average common shares used to compute net income per share | | | |
| Basic | 16,947 | 16,565 | 16,236 |
| Diluted | 17,241 | 17,032 | 16,814 |
| Other comprehensive income (loss) | | | |
| Foreign currency translation adjustments | 336 | (2,119) | (1,470) |
| Unrealized loss on investments (net of tax of \$5, \$31, and \$0) | (9) | (59) | — |
| Comprehensive income | \$ 6,037 | \$ 2,461 | \$ 1,234 |

See accompanying notes to these consolidated financial statements.

SPS COMMERCE, INC.
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY
(In thousands, except share amounts)

| | Common Stock | | Additional Paid-in Capital | Accumulated Deficit | Accumulated Other Comprehensive Loss | Total Stockholders' Equity |
|--|--------------|--------|----------------------------------|------------------------|---|----------------------------------|
| | Shares | Amount | | | | |
| Balances, January 1, 2014 | 16,092,121 | \$ 16 | \$239,549 | \$ (46,792) | \$ — | \$ 192,773 |
| Stock-based compensation | — | — | 5,396 | — | — | 5,396 |
| Exercise of stock options and issuance of restricted stock | 186,678 | — | 1,886 | — | — | 1,886 |
| Excess tax benefit of stock options exercised | — | — | 261 | — | — | 261 |
| Employee stock purchase plan | 26,353 | — | 1,338 | — | — | 1,338 |
| Stock issued for acquisition | 43,595 | — | 2,203 | — | — | 2,203 |
| Net income | — | — | — | 2,704 | — | 2,704 |
| Foreign currency translation adjustments | — | — | — | — | (1,470) | (1,470) |
| Balances, December 31, 2014 | 16,348,747 | 16 | 250,633 | (44,088) | (1,470) | 205,091 |
| Stock-based compensation | — | — | 6,379 | — | — | 6,379 |
| Exercise of stock options and issuance of restricted stock | 346,885 | 1 | 4,439 | — | — | 4,440 |
| Excess tax benefit of stock options exercised | — | — | 2,336 | — | — | 2,336 |
| Employee stock purchase plan | 28,362 | — | 1,478 | — | — | 1,478 |
| Net income | — | — | — | 4,639 | — | 4,639 |
| Foreign currency translation adjustments | — | — | — | — | (2,119) | (2,119) |
| Unrealized loss on investments | — | — | — | — | (59) | (59) |
| Balances, December 31, 2015 | 16,723,994 | 17 | 265,265 | (39,449) | (3,648) | 222,185 |
| Stock-based compensation | — | — | 8,023 | — | — | 8,023 |
| Exercise of stock options and issuance of restricted stock | 279,841 | — | 4,303 | — | — | 4,303 |
| Excess tax benefit of stock options exercised | — | — | 4,070 | — | — | 4,070 |
| Employee stock purchase plan | 33,357 | — | 1,732 | — | — | 1,732 |
| Stock issued for acquisition | 43,953 | — | 2,922 | — | — | 2,922 |
| Net income | — | — | — | 5,710 | — | 5,710 |
| Foreign currency translation adjustments | — | — | — | — | 336 | 336 |
| Reclassification of losses on investments into earnings | — | — | — | — | 18 | 18 |
| Unrealized loss on investments | — | — | — | — | (32) | (32) |
| Balances, December 31, 2016 | 17,081,145 | \$ 17 | \$286,315 | \$ (33,739) | \$ (3,326) | \$ 249,267 |

See accompanying notes to these consolidated financial statements.

SPS COMMERCE, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS
(In thousands)

| | Year Ended December 31, | | |
|---|-------------------------|------------------|------------------|
| | 2016 | 2015 | 2014 |
| Cash flows from operating activities | | | |
| Net income | \$ 5,710 | \$ 4,639 | \$ 2,704 |
| Reconciliation of net income to net cash provided by operating activities | | | |
| Deferred income taxes | (1,698) | (38) | 1,031 |
| Share-based earn-out liability | (1,103) | — | — |
| Depreciation and amortization of property and equipment | 6,598 | 6,265 | 5,714 |
| Amortization of intangible assets | 4,738 | 3,307 | 2,856 |
| Provision for doubtful accounts | 1,375 | 1,271 | 717 |
| Stock-based compensation | 8,023 | 6,379 | 5,396 |
| Changes in assets and liabilities, net of effects of acquisitions | | | |
| Accounts receivable | (3,735) | (3,517) | (3,890) |
| Deferred costs | (4,964) | (3,023) | (4,590) |
| Other current assets and non-current assets | (1,911) | (2,037) | (719) |
| Accounts payable | (382) | (1,569) | 1,271 |
| Accrued compensation | 2,180 | 1,295 | 1,568 |
| Accrued expenses | 990 | (461) | 1,365 |
| Deferred revenue | 2,710 | 587 | 2,440 |
| Deferred rent | 234 | 1,331 | 925 |
| Net cash provided by operating activities | <u>18,765</u> | <u>14,429</u> | <u>16,788</u> |
| Cash flows from investing activities | | | |
| Purchases of property and equipment | (8,008) | (8,757) | (7,582) |
| Purchases of marketable securities | (23,135) | (22,527) | — |
| Maturities of marketable securities | 15,018 | — | — |
| Business acquisitions, net of cash acquired | (18,032) | — | (12,595) |
| Net cash used in investing activities | <u>(34,157)</u> | <u>(31,284)</u> | <u>(20,177)</u> |
| Cash flows from financing activities | | | |
| Net proceeds from exercise of options to purchase common stock | 4,303 | 4,440 | 1,886 |
| Excess tax benefit from exercise of options to purchase common stock | 4,070 | 2,336 | 261 |
| Net proceeds from employee stock purchase plan | 1,732 | 1,478 | 1,338 |
| Net cash provided by financing activities | <u>10,105</u> | <u>8,254</u> | <u>3,485</u> |
| Effect of foreign currency exchange rate changes | (374) | (656) | (595) |
| Net increase (decrease) in cash and cash equivalents | (5,661) | (9,257) | (499) |
| Cash and cash equivalents at beginning of period | <u>121,538</u> | <u>130,795</u> | <u>131,294</u> |
| Cash and cash equivalents at end of period | <u>\$115,877</u> | <u>\$121,538</u> | <u>\$130,795</u> |
| Supplemental disclosure of cash flow information | | | |
| Cash paid for income taxes, net | \$ 722 | \$ 114 | \$ 113 |
| Non-cash financing activities: | | | |
| Common stock issued for business acquisitions | \$ 2,922 | \$ — | \$ 2,203 |

See accompanying notes to these consolidated financial statements.

SPS COMMERCE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE A – General

Business Description

We are a leading provider of cloud-based supply chain management solutions, providing network-proven fulfillment, sourcing and item assortment management solutions, along with comprehensive retail performance analytics, to thousands of customers worldwide. We provide our solutions through the SPS Commerce platform, a cloud-based product suite that improves the way suppliers, retailers, distributors and logistics firms orchestrate the sourcing, set up of new vendors and items, and fulfillment of the products that customers buy from retailers and suppliers. We derive the majority of our revenues from thousands of monthly recurring subscriptions from businesses that utilize our solutions.

Basis of Presentation

The accompanying consolidated financial statements have been prepared in conformity with accounting principles generally accepted in the United States of America (“GAAP”) and include the accounts of SPS Commerce, Inc. and its subsidiaries. All intercompany accounts and transactions have been eliminated in the consolidated financial statements.

Foreign Currency Translation

Assets and liabilities denominated in currencies other than the U.S. dollar are translated into U.S. dollars at the exchange rates in effect at the balance sheet date, with the resulting translation adjustments recorded as a separate component of accumulated other comprehensive loss. Income and expense accounts are translated at the average exchange rates during the year. Foreign currency transaction gains and losses, if any, are included in net income.

Use of Estimates

Preparing financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting periods. Actual results could differ from those estimates.

Business Combinations

We recognize separately from goodwill the fair value of the assets acquired and the liabilities assumed at the acquisition date. Goodwill as of the acquisition date is measured as the excess of consideration transferred and the net of the acquisition date amounts of the assets acquired and the liabilities assumed. Assets acquired include tangible and intangible assets. We use estimates and assumptions that we believe are reasonable as a part of determining the value and useful lives of purchased intangible assets and the purchase price allocation process. While we believe these estimates and assumptions are reasonable, they are inherently uncertain and subject to refinement. As a result, during the measurement period, which may be up to one year from the acquisition date, we may record adjustments to the fair value of the assets acquired and the liabilities assumed. Any such adjustments would be recorded as an offset to goodwill. Upon the conclusion of the measurement period or final determination of the fair values, whichever comes first, any subsequent adjustments would be recorded in our consolidated statements of comprehensive income.

Segment Information

We operate in and report on one segment, which is supply chain management solutions.

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Risk and Uncertainties

We rely on hardware and software licensed from third parties to offer our on-demand solutions. Our management believes alternate sources are available; however, disruption or termination of these relationships could adversely affect our operating results in the near term.

Concentration of Credit Risk

Financial instruments that potentially subject us to concentrations of credit risk consist principally of temporary cash and cash equivalents in financial institutions in excess of federally insured limits and trade accounts receivable. Temporary cash investments are held with financial institutions that we believe are subject to minimal risk.

Cash and Cash Equivalents

Cash and cash equivalents consist of cash and highly liquid investments with original maturities of less than 90 days. Cash and cash equivalents are stated at fair value.

Marketable Securities

Management determines the appropriate classification of marketable securities at the time of purchase and reevaluates such determination at each balance sheet date. Securities are classified as available for sale and are carried at fair value, with the change in unrealized gains and losses, net of tax, reported as a separate component on the consolidated statements of comprehensive income. Fair value is determined based on quoted market rates when observable or utilizing data points that are observable, such as quoted prices, interest rates and yield curves. When a determination has been made that an other-than-temporary decline in fair value has occurred, the amount of the decline that is related to a credit loss is realized and is included in other income (expense), net in the consolidated statements of comprehensive income.

Fair Value of Financial Instruments

The carrying amounts of our financial instruments, which include cash, cash equivalents, accounts receivable, accounts payable and other accrued expenses, approximates fair value due to their short maturities. Marketable securities are recorded at fair value as further described in Note C.

Accounts Receivable

Accounts receivable are initially recorded upon the sale of solutions to customers. Credit is granted in the normal course of business without collateral. Accounts receivable are stated net of allowances for doubtful accounts, which represent estimated losses resulting from the inability of certain customers to make the required payments. When determining the allowances for doubtful accounts, we take several factors into consideration including the overall composition of the accounts receivable aging, our prior history of accounts receivable write-offs, the type of customers and our experience with specific customers. We write off accounts receivable when they are determined to be uncollectible. Changes in the allowances for doubtful accounts are recorded as bad debt expense and are included in general and administrative expense in our consolidated statements of comprehensive income.

Property and Equipment

Property and equipment, including assets acquired under capital lease obligations, are stated at cost, net of accumulated depreciation and amortization. Depreciation and amortization are computed using the straight-line method over the estimated useful lives when placed in service, which are:

Computer equipment and software: 2 to 3 years

Office equipment and furniture: 5 to 7 years

Leasehold improvements: the shorter of the useful life of the asset or the remaining term of the lease

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Significant additions or improvements extending asset lives beyond one year are capitalized, while repairs and maintenance are charged to expense as incurred. We also capitalize and amortize eligible costs to acquire or develop internal-use software that are incurred during the development stage. The assets and related accumulated depreciation and amortization are adjusted for asset retirements and disposals with the resulting gain or loss included in our consolidated statements of comprehensive income.

Research and Development

Research and development costs primarily include maintenance and data conversion activities related to our cloud-based supply chain management solutions and are expensed as incurred.

Goodwill

Goodwill represents the excess of the purchase price over the fair value of identifiable net assets acquired in business combinations. We test goodwill for impairment annually at November 30, or more frequently if events or changes in circumstances indicate that the asset might be impaired. The impairment test is conducted by comparing the fair value of the net assets with the carrying value of the reporting unit. Fair value is determined using the direct market observation of market price and outstanding equity of the reporting unit at the testing date. If the carrying value of the goodwill exceeds the fair value of the reporting unit, goodwill may be impaired. If this occurs, the fair value is then allocated to its assets and liabilities in a manner similar to a purchase price allocation in order to determine the implied fair value of goodwill. This implied fair value is then compared to the carrying amount of goodwill and, if it is less, we would recognize an impairment loss.

During 2016, we changed our annual impairment testing date from December 31 to November 30. This voluntary change in accounting principle, applied prospectively, is preferable as it allows more timely completion of our annual impairment test and does not delay, accelerate, or avoid an impairment charge.

Intangible Assets

Assets acquired in business combinations may include identifiable intangible assets such as subscriber relationships and non-competition agreements. We recognize separately from goodwill the fair value of the identifiable intangible assets acquired. We have determined the fair value and useful lives of our purchased intangible assets using certain estimates and assumptions that we believe are reasonable.

The purchased intangible assets are being amortized on a straight-line basis over their estimated useful lives, which are three to nine years for subscriber relationships, two to five years for non-competition agreements and one to four years for technology and other.

Impairment of Long-Lived Assets

We review our long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying amount may not be recoverable. The carrying amount of a long-lived asset is not recoverable if the carrying amount of an asset group exceeds the sum of the undiscounted cash flows expected to result from the use and eventual disposition of the assets at the date it is tested for recoverability, whether in use or under development. An impairment loss is measured as the amount by which the carrying amount of a long-lived asset exceeds its fair value.

Revenue Recognition

We generate revenues by providing a number of solutions to our customers. These solutions include Trading Partner Fulfillment, Trading Partner Enablement and Trading Partner Analytics. Our cloud-based solutions allow customers to meet their supply chain management requirements. Sales taxes are presented on a net basis within revenue.

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Revenues are recognized when all of the following criteria are met: (1) persuasive evidence of an arrangement exists, (2) delivery has occurred, (3) the fee is fixed or determinable, and (4) collectability is probable. If collection is not considered probable, revenues are recognized when the fees are collected.

Fees related to our Trading Partner Fulfillment and Trading Partner Analytics solutions consist of two revenue sources: set-up fees and recurring monthly fees. Set-up fees are specific for each connection a customer has with a trading partner and most of our customers have connections with numerous trading partners. Set-up fees are nonrefundable upfront fees that do not have standalone value to our customer and are not separable from the recurring monthly fees. All set-up fees and related costs are deferred and recognized ratably over the average life of the connection between the customer and the trading partner, which is approximately two years. We begin recognizing set-up fee revenue once the connection is established. Set-up fees for which connections have not yet been established are classified as long-term. We continue to evaluate the length of the amortization period as more experience is gained with cancellations and technology changes requested by our customers. It is possible that, in the future, the period over which such subscription set-up fees and costs are amortized may be adjusted. Any change in our estimate of the average connection life will affect our future results of operations. The recurring monthly fees are comprised of both fixed and transaction-based fees that are recognized as earned.

Stock-Based Compensation

We recognize the cost of all share-based payments to employees, including grants of employee stock options, in the financial statements based on the grant date fair value of those awards. This cost is recognized over the period for which an employee is required to provide service in exchange for the award. Benefits associated with tax deductions in excess of recognized compensation expense are reported as a cash flow from financing activities.

We estimate the fair value of options granted using the Black-Scholes option pricing model. The estimation of stock awards that will ultimately vest requires judgment, and to the extent actual results differ from our estimates, such amounts will be recorded as an adjustment in the period estimates are revised. In valuing share-based awards, judgment is required in determining the expected volatility of common stock and the expected term individuals will hold their share-based awards prior to exercising. The expected volatility of the options is based on the historical volatility of our common stock. The expected term of the options is based on the simplified method which does not consider historical employee exercise behavior.

Advertising Costs

Advertising costs are charged to expense as incurred. Advertising costs were approximately \$61,000, \$47,000, and \$23,000 for the years ended December 31, 2016, 2015 and 2014, respectively. Advertising costs are included in sales and marketing expenses in our consolidated statements of comprehensive income.

Income Taxes

We account for income taxes using the liability method, which requires recognition of deferred tax assets and liabilities for the expected future tax consequences of events that have been included in the consolidated financial statements. Under this method, deferred tax assets and liabilities are determined based on the difference between the financial statement and tax basis of assets and liabilities using enacted tax rates in effect for the year in which the differences are expected to reverse. Deferred tax assets are reduced by a valuation allowance when it is not "more likely than not" that the deferred tax asset will be utilized.

We assess our ability to realize our deferred tax assets at the end of each reporting period. Realization of our deferred tax assets is contingent upon future taxable earnings. Accordingly, this assessment requires significant estimates and judgment. If the estimates of future taxable income vary from actual results, our assessment

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regarding the realization of these deferred tax assets could change. Future changes in the estimated amount of deferred taxes expected to be realized will be reflected in our consolidated financial statements in the period the estimate is changed, with a corresponding adjustment to our operating results.

We recognize the financial statement benefit of a tax position only after determining that the relevant tax authority would “more likely than not” sustain the position following an audit. For tax positions meeting the “more likely than not” threshold, the amount recognized in the financial statements is the largest benefit that has a greater than 50% likelihood of being realized upon ultimate settlement with the relevant tax authority.

Net Income Per Share

Basic net income per share has been computed using the weighted average number of shares of common stock outstanding during each period. Diluted net income per share also includes the impact of our outstanding potential common shares, including options, restricted stock units and restricted stock awards. Potential common shares that are anti-dilutive are excluded from the calculation of diluted net income per share.

Recent Accounting Pronouncements

In May 2014, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update (“ASU”) No. 2014-09, Revenue from Contracts with Customers (Topic 606), which requires an entity to recognize the amount of revenue to which it expects to be entitled for the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. This guidance will replace most existing revenue recognition guidance in GAAP when it becomes effective. These new requirements are effective for annual reporting periods beginning after December 15, 2017, and interim periods within those annual periods. We do not believe the new revenue recognition standard will materially impact our recognition of the primary fees received from customers for our cloud-based supply chain solutions. We believe the adoption of the new standard could impact our accounting for certain upfront set-up fees and the periods over which the related revenues are recognized, as well as the timing of cost recognition for sales commissions and other contract acquisition costs. We are currently evaluating implementation methods and the extent of the impact that implementation of this standard will have on our consolidated financial statements upon adoption.

In November 2015, the FASB issued ASU No. 2015-17, *Balance Sheet Classification of Deferred Taxes*, which amends the guidance requiring companies to separate deferred income tax liabilities and assets into current and non-current amounts in a classified statement of financial position. This accounting guidance simplifies the presentation of deferred income taxes, such that deferred tax liabilities and assets be classified as non-current in a classified statement of financial position. This accounting guidance is effective for us beginning in the first quarter of 2017, but we elected to early adopt this guidance prospectively as of December 31, 2015. As a result, we have classified all deferred tax liabilities and assets as non-current in the condensed consolidated balance sheet as of December 31, 2016 and December 31, 2015.

In February 2016, the FASB issued ASU 2016-02, *Leases* which will supersede the existing lease guidance and will require all leases with a term greater than 12 months to be recognized in the statements of financial position and eliminate current real estate-specific lease guidance, while maintaining substantially similar classification criteria for distinguishing between finance leases and operating leases. This standard is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018, with early adoption permitted. We believe the adoption of the new lease accounting standard will materially impact our consolidated financial statements by increasing our non-current assets and non-current liabilities on our consolidated balance sheets in order to record the right of use assets and related lease liabilities for our existing operating leases. We are in the process of determining the financial statement impact and are currently unable to estimate the impact on our consolidated financial statements.

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In March 2016, the FASB issued ASU 2016-09, Improvements to Employee Share-Based Payment Accounting, which permits entities to make an accounting policy election related to how forfeitures will impact the recognition of compensation cost for stock-based compensation, and also eliminates the requirement that excess tax benefits be realized as a reduction in current taxes payable before the associated tax benefit can be recognized as an increase in paid in capital. This standard is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2016, with early adoption permitted. We expect that our previously unrecognized federal and state net operating losses (\$46.2 million and \$10.7 million, respectively, as of December 31, 2016) will be included in the deferred tax assets recognized in our consolidated balance sheets on a modified retrospective basis as of January 1, 2017. With the adoption of ASU 2016-09 we will also be required to present excess tax benefits as an operating activity in the same manner as other cash flows related to income taxes on the statement of cash flows rather than as a financing activity.

NOTE B – Business Acquisitions

Toolbox Solutions, Inc.

On January 5, 2016, we completed our acquisition of all of the outstanding common shares of Toolbox Solutions, Inc. (“Toolbox Solutions”), a privately held company providing point-of-sale analytics and category management services to retailers and consumer packaged goods suppliers in North America. This acquisition expanded our retail network and strengthened our analytics offerings. Pursuant to the share purchase agreement, we paid \$18.0 million in cash and issued \$2.9 million in stock, or 43,953 shares of common stock, to the shareholders of Toolbox Solutions. The purchase agreement also allowed the sellers to receive up to 16,222 additional shares of common stock, which would have become payable contingent upon the completion of certain revenue milestones, none of which were met, and therefore, no additional shares were issued. During the year ended December 31, 2016, we recognized other income of \$1.1 million in our consolidated statements of comprehensive income due to the remeasurement of this contingent liability.

Purchase Price Allocation

We accounted for the acquisition as a business combination. We allocated the purchase price to the tangible and identifiable intangible assets acquired and liabilities assumed based on their estimated fair values as of the acquisition date. We engaged a third-party valuation firm to assist us in the determination of the value of the purchased intangible assets. The excess of the purchase price over the fair value of net tangible and identifiable intangible assets acquired was recorded as goodwill. Goodwill is attributed to a trained workforce and other buyer-specific value resulting from expected synergies, including long-term cost savings, which are not included in the fair values of identifiable assets.

The purchase price consisted of the following (in thousands):

| | |
|--|-----------------|
| Cash | \$18,032 |
| SPS Commerce, Inc. common stock | 2,922 |
| Fair value of share-based earn-out liability | 1,043 |
| | <u>\$21,997</u> |

The final purchase price was subject to a net working capital adjustment to be determined by us and the sellers, pursuant to the terms of the purchase agreement. The number of shares of our common stock issued for the acquisition was a net of 43,953 shares, which consisted of 48,668 shares issued at closing, as calculated according to the terms of the purchase agreement, less 4,715 shares that were returned to us from escrow in the fourth quarter of 2016.

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The following table summarizes the estimated fair values of the assets acquired, net of cash acquired of \$359,000, and liabilities assumed at the acquisition date (in thousands):

| | |
|-------------------------------|-----------------|
| Current assets | \$ 1,253 |
| Property and equipment | 56 |
| Goodwill | 15,389 |
| Intangible assets | 9,070 |
| Current liabilities | (1,249) |
| Deferred revenue | (301) |
| Deferred income tax liability | (2,221) |
| | <u>\$21,997</u> |

Purchased Intangible Assets

The following table summarizes the estimated fair value of the purchased intangible assets and their estimated useful lives:

| <u>Purchased Intangible Assets</u> | <u>Estimated Fair Value (in thousands)</u> | <u>Estimated Life (in years)</u> |
|------------------------------------|--|--|
| Subscriber relationships | \$ 7,400 | 8 |
| Developed technology | 1,200 | 4 |
| Trade names | 70 | 1 |
| Non-competition agreements | 400 | 5 |
| Total | <u>\$ 9,070</u> | |

The purchased intangible assets are being amortized on a straight-line basis over their estimated useful lives. Amortization expense for the period from January 5, 2016 through December 31, 2016 was \$1.4 million.

Acquisition-Related Costs and Post-Acquisition Operating Results

Acquisition-related costs were \$147,000 and are included in our consolidated statement of comprehensive income for the year ended December 31, 2016. The operating results of Toolbox Solutions have been included in our consolidated financial statements from January 5, 2016, the closing date of the acquisition. For the period from January 5, 2016 through December 31, 2016, approximately \$7.9 million of our revenues were derived from Toolbox Solutions' products and services. The amount of operating income or loss from Toolbox Solutions was not separately identifiable due to our integration.

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Unaudited Pro Forma Financial Information

The unaudited pro forma financial information in the table below presents the combined operating results of SPS Commerce and Toolbox Solutions as if the acquisition had occurred on January 1, 2015. The unaudited pro forma information includes the historical operating results of each company and pro forma adjustments for the approximately \$1.4 million of annual amortization expense related to purchased intangible assets and the additional impact on the provision or benefit for income taxes, resulting from the combined income and intangible amortization expense, using our statutory blended income tax rate of 26.5%.

| (in thousands, except per share data) | Year Ended December 31, | |
|---------------------------------------|----------------------------|-----------|
| | 2016 | 2015 |
| Pro forma total revenue | \$193,525 | \$166,873 |
| Pro forma net income | 5,976 | 2,400 |
| Pro forma net income per share | | |
| Basic | 0.35 | 0.14 |
| Diluted | 0.35 | 0.14 |

The unaudited pro forma financial information is presented for informational purposes only and is not necessarily indicative of the results of operations that would have actually been reported had the acquisition occurred on January 1, 2015, nor is it necessarily indicative of our results of operations for any future periods.

Leadtec

On October 12, 2014, we entered into and completed an asset purchase agreement with Leadtec Systems Australia Pty Ltd (“Leadtec”), and its affiliates, Advanced Barcode Solutions Pty Ltd, Scott Needham and Leading Technology Group Pty Ltd. Leadtec is in the business of cloud-based integration solutions. Pursuant to the asset purchase agreement, we purchased and acquired from Leadtec substantially all of the assets used in Leadtec’s business and assumed certain liabilities of Leadtec, all of which were recorded in Australian dollars. We paid \$12.6 million in cash and issued 43,595 shares of our common stock for this acquisition, which expanded our base of recurring revenue customers and added suppliers to our network.

Purchase Price Allocation

We accounted for the acquisition as a business combination. We allocated the purchase price to the tangible and identifiable intangible assets acquired and liabilities assumed based on their estimated fair values as of the acquisition date. The excess of the purchase price over the fair value of net tangible and identifiable intangible assets acquired was recorded as goodwill. Goodwill is attributed to buyer-specific value resulting from expected synergies, including long-term cost savings, as well as a trained workforce which are not included in the fair values of assets. Goodwill will not be amortized; however the value is deductible for tax purposes.

The purchase price consisted of the following (in thousands):

| | |
|---------------------------------|-----------------|
| Cash | \$12,595 |
| SPS Commerce, Inc. common stock | 2,203 |
| | <u>\$14,798</u> |

The number of shares of our common stock issued for the acquisition was 43,595 shares as calculated according to the terms of the purchase agreement. The fair value of the shares issued was approximately \$2.2 million and was determined using the closing price of our common stock on October 10, 2014.

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The following table summarizes the estimated fair values of the assets acquired and liabilities assumed at the acquisition date (in thousands):

| | |
|--------------------------|-----------------|
| Current and other assets | \$ 659 |
| Property and equipment | 143 |
| Goodwill | 9,954 |
| Intangible assets | 4,891 |
| Current liabilities | (849) |
| | <u>\$14,798</u> |

Purchased Intangible Assets

The following table summarizes the estimated fair value of the purchased intangible assets and their estimated useful lives:

| <u>Purchased Intangible Assets</u> | <u>Estimated Fair Value (in thousands)</u> | <u>Estimated Life (in years)</u> |
|------------------------------------|--|--|
| Subscriber relationships | \$ 3,778 | 9 |
| Non-competition agreements | 148 | 5 |
| Technology and other | 965 | 2.5 |
| Total | <u>\$ 4,891</u> | |

The purchased intangible assets are being amortized on a straight-line basis over their estimated useful lives. Amortization expense related to these intangible assets was \$733,000 for the year ended December 31, 2015 and \$168,000 for the period from October 12, 2014 through December 31, 2014.

Acquisition-Related Costs and Post-Acquisition Operating Results

Acquisition-related costs were \$690,000, including \$338,000 for a one-time Australian stamp duty tax, and are included in our consolidated statement of comprehensive income for the year ended December 31, 2014. The operating results of Leadtec have been included in our consolidated financial statements from October 12, 2014, the closing date of the acquisition. For the period from October 12, 2014 through December 31, 2014, revenues of approximately \$1.2 million and an operating loss of approximately \$280,000 were attributable to Leadtec.

Unaudited Pro Forma Financial Information

The unaudited pro forma financial information in the table below presents the combined operating results of SPS Commerce and Leadtec as if the acquisition had occurred on January 1, 2013. The unaudited pro forma information includes the historical operating results of each company and pro forma adjustments for annual amortization expense related to purchased intangible assets and the expected tax impact considering our current tax elections and representations.

| <u>(in thousands, except per share data)</u> | <u>Year Ended December 31, 2014</u> |
|--|---|
| Pro forma total revenue | \$ 132,818 |
| Pro forma net income | 2,973 |
| Pro forma net income per share | |
| Basic | 0.18 |
| Diluted | 0.18 |

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The unaudited pro forma financial information is presented for informational purposes only and is not necessarily indicative of the results of operations that would have actually been reported had the acquisition occurred on January 1, 2013, nor is it necessarily indicative of our results of operations for any future periods.

NOTE C – Financial Instruments

We invest primarily in money market funds, highly liquid debt instruments of the U.S. government, and U.S. corporate debt securities. All highly liquid investments with original maturities of 90 days or less are classified as cash equivalents. All investments with original maturities greater than 90 days and remaining maturities less than one year from the balance sheet date are classified as short-term marketable securities. Investments with remaining maturities of more than one year from the balance sheet date are classified as marketable securities, non-current. Short-term marketable securities and marketable securities, non-current, are also classified as available-for-sale. We intend to hold marketable securities until maturity; however, we may sell these securities at any time for use in current operations or for other purposes. Consequently, we may or may not keep securities with stated holding periods to maturity.

Our fixed income investments are carried at fair value and unrealized gains and losses on these investments, net of taxes, are included in accumulated other comprehensive loss in the consolidated balance sheets. Realized gains or losses are included in other income (expense) in the consolidated statements of comprehensive income. When a determination has been made that an other-than-temporary decline in fair value has occurred, the amount of the decline that is related to a credit loss is realized and is included in other income (expense), net in the consolidated statements of comprehensive income.

Cash equivalents and marketable securities, consisted of the following (in thousands):

| | December 31, | | | | | |
|--------------------------|-------------------|------------------------------|------------------|-------------------|------------------------------|------------------|
| | 2016 | | | 2015 | | |
| | Amortized Cost | Unrealized Gains (Losses) | Fair Value | Amortized Cost | Unrealized Gains (Losses) | Fair Value |
| Cash equivalents: | | | | | | |
| Money market funds | \$ 75,375 | \$ — | \$ 75,375 | \$ 79,717 | \$ — | \$ 79,717 |
| Marketable securities: | | | | | | |
| Corporate bonds | 15,681 | (96) | 15,585 | 10,042 | (34) | 10,008 |
| Commercial paper | 4,977 | 10 | 4,987 | 2,499 | 1 | 2,500 |
| U.S. treasury securities | 7,489 | 10 | 7,499 | 7,489 | (27) | 7,462 |
| U.S. agency obligations | 2,497 | 3 | 2,500 | 2,497 | 1 | 2,498 |
| | <u>\$106,019</u> | <u>\$ (73)</u> | <u>\$105,946</u> | <u>\$102,244</u> | <u>\$ (59)</u> | <u>\$102,185</u> |
| Due within one year | | | \$ 98,452 | | | \$ 87,235 |
| Due within two years | | | 7,494 | | | 14,950 |
| Total | | | <u>\$105,946</u> | | | <u>\$102,185</u> |

We do not believe any of the unrealized losses represent an other-than-temporary impairment based on our assessment of available evidence as of December 31, 2016. We expect to receive the full principal and interest on all of these cash equivalents and marketable securities.

Fair Value Measurements

We measure certain financial assets at fair value on a recurring basis based on a fair value hierarchy that requires us to maximize the use of observable inputs and minimize the use of unobservable inputs when

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measuring fair value. A financial instrument's categorization within the fair value hierarchy is based upon the lowest level of input that is significant to the fair value measurement. The three levels of inputs that may be used to measure fair value are:

- Level 1 — quoted prices in active markets for identical assets or liabilities
- Level 2 — observable inputs other than Level 1 prices, such as (a) quoted prices for similar assets or liabilities, (b) quoted prices in markets with insufficient volume or infrequent transactions (less active markets), or (c) model-derived valuations in which all significant inputs are observable or can be derived principally from or corroborated by observable market data for substantially the full term of the assets or liabilities.
- Level 3 — unobservable inputs to the valuation methodology that are significant to the measurement of fair value of assets or liabilities.

Level 1 Measurements

Our cash equivalents held in money market funds are measured at fair value using level 1 inputs.

Level 2 Measurements

Our available-for-sale U.S. treasury securities, U.S. agency obligations, commercial paper and corporate debt securities are measured at fair value using level 2 inputs. We obtain the fair values of our level 2 available-for-sale securities from a professional pricing service.

The following table presents information about our financial assets that are measured at fair value on a recurring basis and indicates the fair value hierarchy of the valuation techniques utilized to determine such fair value (in thousands):

| | <u>Level 1</u> | <u>Level 2</u> | <u>Level 3</u> | <u>Total</u> |
|------------------------------|-----------------|-----------------|----------------|------------------|
| Assets at December 31, 2016: | | | | |
| Cash and cash equivalents: | | | | |
| Money market funds | \$75,375 | \$ — | \$ — | \$ 75,375 |
| Marketable securities: | | | | |
| Corporate bonds | — | 15,585 | — | 15,585 |
| Commerical paper | — | 4,987 | — | 4,987 |
| U.S. treasury securities | — | 7,499 | — | 7,499 |
| U.S. agency obligations | — | 2,500 | — | 2,500 |
| | <u>\$75,375</u> | <u>\$30,571</u> | <u>\$ —</u> | <u>\$105,946</u> |
| Assets at December 31, 2015: | | | | |
| Cash and cash equivalents: | | | | |
| Money market funds | \$79,717 | \$ — | \$ — | \$ 79,717 |
| Marketable securities: | | | | |
| Corporate bonds | — | 10,008 | — | 10,008 |
| Commerical paper | — | 2,500 | — | 2,500 |
| U.S. treasury securities | — | 7,462 | — | 7,462 |
| U.S. agency obligations | — | 2,498 | — | 2,498 |
| | <u>\$79,717</u> | <u>\$22,468</u> | <u>\$ —</u> | <u>\$102,185</u> |

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NOTE D – Allowance for Doubtful Accounts

The allowance for doubtful accounts activity, included in accounts receivable, net, was as follows (in thousands):

| | <u>2016</u> | <u>2015</u> | <u>2014</u> |
|---------------------------------|----------------|----------------|---------------|
| Balances, January 1 | \$ 446 | \$ 279 | \$ 237 |
| Provision for doubtful accounts | 1,375 | 1,271 | 717 |
| Write-offs, net of recoveries | <u>(1,306)</u> | <u>(1,104)</u> | <u>(675)</u> |
| Balances, December 31 | <u>\$ 515</u> | <u>\$ 446</u> | <u>\$ 279</u> |

NOTE E – Property and Equipment, net

Property and equipment, net included the following (in thousands):

| | <u>December 31,</u> | |
|---|---------------------|------------------|
| | <u>2016</u> | <u>2015</u> |
| Computer equipment and software | \$ 29,270 | \$ 27,725 |
| Office equipment and furniture | 7,087 | 5,793 |
| Leasehold improvements | <u>7,844</u> | <u>5,530</u> |
| | 44,201 | 39,048 |
| Less: accumulated depreciation and amortization | <u>(28,887)</u> | <u>(25,428)</u> |
| | <u>\$ 15,314</u> | <u>\$ 13,620</u> |

At December 31, 2016 and 2015, property and equipment, net included approximately \$2.1 million and \$709,000, respectively, of assets held at subsidiary and office locations outside of the United States of America.

NOTE F – Goodwill and Intangible Assets, net

The changes in the net carrying amount of goodwill for the years ended December 31, 2016 and 2015 are as follows (in thousands):

| | <u>2016</u> | <u>2015</u> |
|--------------------------------------|-----------------|-----------------|
| Balances, January 1 | \$33,848 | \$34,854 |
| Additions from business acquisitions | 15,389 | — |
| Foreign currency translation | 540 | <u>(1,006)</u> |
| Balances, December 31 | <u>\$49,777</u> | <u>\$33,848</u> |

Intangible assets, net included the following (in thousands):

| | <u>December 31, 2016</u> | | | |
|----------------------------|----------------------------|-------------------------------------|---|-----------------|
| | <u>Carrying Amount</u> | <u>Accumulated Amortization</u> | <u>Foreign Currency Translation</u> | <u>Net</u> |
| Subscriber relationships | \$33,736 | \$ (15,708) | \$ 295 | \$18,323 |
| Non-competition agreements | 2,234 | (1,818) | 17 | 433 |
| Technology and other | <u>2,089</u> | <u>(1,120)</u> | <u>63</u> | <u>1,032</u> |
| | <u>\$38,059</u> | <u>\$ (18,646)</u> | <u>\$ 375</u> | <u>\$19,788</u> |

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| | December 31, 2015 | | | |
|----------------------------|-------------------|--------------------------|------------------------------|-----------------|
| | Carrying Amount | Accumulated Amortization | Foreign Currency Translation | Net |
| Subscriber relationships | \$26,701 | \$ (11,856) | \$ (364) | \$14,481 |
| Non-competition agreements | 1,843 | (1,653) | (9) | 181 |
| Technology and other | 905 | (400) | (86) | 419 |
| | <u>\$29,449</u> | <u>\$ (13,909)</u> | <u>\$ (459)</u> | <u>\$15,081</u> |

Amortization expense was \$4.7 million, \$3.3 million, and \$2.9 million for the years ended December 31, 2016, 2015, and 2014, respectively. At December 31, 2016, future amortization expense for intangible assets was as follows (in thousands):

| | |
|------------|-----------------|
| 2017 | \$ 4,380 |
| 2018 | 3,793 |
| 2019 | 3,502 |
| 2020 | 3,174 |
| 2021 | 2,381 |
| Thereafter | 2,558 |
| | <u>\$19,788</u> |

NOTE G – Commitments and Contingencies

Operating Leases

We are obligated under non-cancellable operating leases primarily for office space. Rent expense for all operating leases which includes minimum lease payments and other charges, such as common area maintenance fees, charged to operations was \$5.0 million, \$4.6 million and \$3.7 million for the years ended December 31, 2016, 2015 and 2014, respectively.

On June 30, 2016, we executed a new lease agreement at our Toronto office location which commenced on January 1, 2017 and expires on December 31, 2021. The lease includes a right of first offer to lease certain additional space and one option to extend the term of the lease for five years at a market rate determined in accordance with the lease. There was also a rent holiday of two months which has been incorporated into our deferred rent calculation.

On September 1, 2015, we executed a new lease agreement at our New Jersey office location which commenced on February 1, 2016 and expires on June 30, 2023. The lease includes a right of first offer to lease certain additional space and one option to extend the term of the lease for five years at a market rate determined in accordance with the lease. There was also a rent holiday of five months which has been incorporated into our deferred rent calculation.

On February 14, 2012, we executed a new lease agreement for our current headquarters location which commenced on November 1, 2012 and expires on April 30, 2020. The lease includes additional square footage upon commencement, a right of first offer to lease certain additional space, which we exercised, and two options to extend the term of the lease for three years at a market rate determined in accordance with the lease. There was also a rent holiday from November 2012 to October 2013 which has been incorporated into our deferred rent calculation.

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At December 31, 2016, our future minimum payments under operating leases were as follows (in thousands):

| | |
|------------|-----------------|
| 2017 | \$ 3,318 |
| 2018 | 3,123 |
| 2019 | 3,220 |
| 2020 | 1,825 |
| 2021 | 1,047 |
| Thereafter | 1,174 |
| | <u>\$13,707</u> |

Other Contingencies

We may be involved in various claims and legal actions in the normal course of business. Our management believes that the outcome of any such claims and legal actions will not have a material effect on our financial position, results of operations or cash flows.

NOTE H – Stockholders' Equity**Common Stock Issued**

In connection with the acquisition of Toolbox Solutions (see Note B), we issued a net of 43,953 shares which consisted of 48,668 shares issued at closing, as calculated according to the terms of the purchase agreement, less 4,715 shares that were returned to us from escrow in the fourth quarter of 2016. The fair value of the shares we issued, approximately \$2.9 million, was determined using the closing price of our common stock on January 5, 2016.

On October 12, 2014, in connection with the acquisition of Leadtec (see Note B), we issued 43,595 shares of our common stock. The fair value of the shares we issued, approximately \$2.2 million, was determined using the closing price of our common stock on October 10, 2014.

NOTE I – Stock-Based Compensation

Our equity compensation plans provide for the grant of incentive and nonqualified stock options, as well as other stock-based awards including restricted stock and restricted stock units, to employees, non-employee directors and other consultants who provide services to us. Restricted stock awards result in the issuance of new shares when granted. For other stock-based awards, new shares are issued when the award is exercised, vested or released according to the terms of the agreement. In February 2016, 1,003,439 additional shares were reserved for future issuance under our 2010 Equity Incentive Plan. At December 31, 2016, there were approximately 3.9 million shares available for grant under approved equity compensation plans.

We recorded stock-based compensation expense of \$8.0 million, \$6.4 million and \$5.4 million for the years ended December 31, 2016, 2015 and 2014, respectively. This expense was allocated as follows (in thousands):

| | Year Ended December 31, | | |
|--|-------------------------|----------------|----------------|
| | 2016 | 2015 | 2014 |
| Cost of revenues | \$1,309 | \$ 989 | \$ 614 |
| Operating expenses | | | |
| Sales and marketing | 2,412 | 1,978 | 1,933 |
| Research and development | 618 | 640 | 444 |
| General and administrative | 3,684 | 2,772 | 2,405 |
| Total stock-based compensation expense | <u>\$8,023</u> | <u>\$6,379</u> | <u>\$5,396</u> |

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As of December 31, 2016, there was approximately \$13.7 million of unrecognized stock-based compensation expense under our equity compensation plans, which is expected to be recognized on a straight line basis over a weighted average period of 2.56 years.

Stock Options

Stock options generally vest over four years and have a contractual term of seven to ten years from the date of grant. Our stock option activity was as follows:

| | Options (#) | Weighted Average Exercise Price (\$/share) |
|----------------------------------|------------------|--|
| Outstanding at January 1, 2014 | 1,097,223 | \$ 19.62 |
| Granted | 153,770 | 62.86 |
| Exercised | (153,196) | 12.27 |
| Forfeited | (12,334) | 41.38 |
| Outstanding at December 31, 2014 | 1,085,463 | 26.53 |
| Granted | 181,487 | 67.50 |
| Exercised | (305,106) | 14.55 |
| Forfeited | (18,741) | 45.82 |
| Outstanding at December 31, 2015 | 943,103 | 37.91 |
| Granted | 340,609 | 48.58 |
| Exercised | (221,630) | 19.42 |
| Forfeited | (46,070) | 55.58 |
| Outstanding at December 31, 2016 | <u>1,016,012</u> | 44.72 |

Of the total outstanding options at December 31, 2016, 582,650 were exercisable with a weighted average exercise price of \$38.43 per share. The total outstanding options had a weighted average remaining contractual life of 4.6 years.

The fair value of options that vested during the years ended December 31, 2016, 2015 and 2014 was \$3.4 million, \$3.1 million and \$2.9 million, respectively.

The intrinsic value of options exercised during the years ended December 31, 2016, 2015 and 2014 was \$8.6 million, \$16.8 million and \$7.4 million, respectively. The intrinsic value of outstanding options at December 31, 2016, 2015 and 2014 was \$25.6 million, \$30.5 million and \$33.8 million, respectively.

The weighted-average fair values per share of options granted during 2016, 2015 and 2014 were \$16.13, \$23.09 and \$24.36, respectively. The fair values of the options granted were estimated on the date of grant using the Black-Scholes option pricing model with the following weighted-average assumptions:

| | Year Ended December 31, | | |
|-------------------------|-------------------------|-------|-------|
| | 2016 | 2015 | 2014 |
| Volatility | 38% | 39% | 42% |
| Dividend yield | — | — | — |
| Life (in years) | 4.54 | 4.52 | 4.17 |
| Risk-free interest rate | 1.19% | 1.36% | 1.44% |

The expected volatility of the options is based on the historical volatility of our common stock. We have not issued dividends on our common stock and do not expect to do so in the foreseeable future. The expected term of the options is based on the simplified method which does not consider historical employee exercise behavior. The risk-free interest rate is based on the U.S. Treasury rates at the date of grant with maturity dates approximately equal to the expected life at the grant date.

[Table of Contents](#)**Restricted Stock Units and Awards**

Restricted stock units vest over four years and, upon vesting, the holder is entitled to receive shares of our common stock. With restricted stock awards, shares of our common stock are issued when the award is granted and the restrictions lapse over one year.

Our restricted stock units activity was as follows:

| | Restricted Stock Units (#) | Weighted Average Grant Date Fair Value (\$/share) |
|----------------------------------|---------------------------------------|--|
| Outstanding at January 1, 2014 | 102,644 | \$ 33.77 |
| Granted | 42,001 | 64.89 |
| Vested and common stock issued | (28,367) | 32.92 |
| Forfeited | (1,145) | 35.42 |
| Outstanding at December 31, 2014 | 115,133 | 45.25 |
| Granted | 68,159 | 67.50 |
| Vested and common stock issued | (37,669) | 40.91 |
| Forfeited | (5,058) | 54.28 |
| Outstanding at December 31, 2015 | 140,565 | 56.88 |
| Granted | 115,896 | 48.32 |
| Vested and common stock issued | (52,133) | 48.19 |
| Forfeited | (15,286) | 55.48 |
| Outstanding at December 31, 2016 | <u>189,042</u> | 54.14 |

The number of restricted stock units outstanding at December 31, 2016 included 34,190 units that have vested, but the shares of common stock have not yet been issued pursuant to the terms of the agreement.

Our restricted stock awards activity was as follows:

| | Restricted Stock Awards (#) | Weighted Average Grant Date Fair Value (\$/share) |
|----------------------------------|--|--|
| Outstanding at January 1, 2014 | 1,422 | \$ 48.66 |
| Restricted common stock issued | 5,352 | 51.74 |
| Restrictions lapsed | (5,199) | 51.04 |
| Forfeited | (237) | 48.66 |
| Outstanding at December 31, 2014 | 1,338 | 51.74 |
| Restricted common stock issued | 4,110 | 67.37 |
| Restrictions lapsed | (4,416) | 62.63 |
| Forfeited | — | — |
| Outstanding at December 31, 2015 | 1,032 | 67.39 |
| Restricted common stock issued | 6,078 | 52.27 |
| Restrictions lapsed | (5,586) | 55.06 |
| Forfeited | — | — |
| Outstanding at December 31, 2016 | <u>1,524</u> | 52.28 |

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Employee Stock Purchase Plan

Effective July 1, 2012, we adopted an employee stock purchase plan which allows participating employees to purchase shares of our common stock at a discount through payroll deductions. The plan is available to all employees subject to certain eligibility requirements. Participating employees may purchase common stock, on a voluntary after tax basis, at a price that is the lower of 85% of the fair market value of one share of common stock at the beginning or end of each stock purchase period. The plan consists of two six-month offering periods, beginning on January 1 and July 1 of each calendar year. A total of 1.1 million shares of common stock are reserved for issuance under the plan.

For the offering periods in 2016, we withheld approximately \$1.7 million from employees participating in the plan and we purchased 33,357 shares on their behalf. For the offering periods in 2015, we withheld approximately \$1.5 million from employees participating in the plan and we purchased 28,362 shares on their behalf. For the offering periods in 2014, we withheld approximately \$1.3 million from employees participating in the plan and we purchased 26,353 shares on their behalf.

For the years ended December 31, 2016, 2015 and 2014, we recorded approximately \$552,000, \$408,000 and \$473,000 of stock-based compensation expense associated with the employee stock purchase plan. The fair value was estimated based on the market price of our common stock at the beginning of each offering period and using the Black-Scholes option pricing model with the following weighted-average assumptions:

| | Year Ended December 31, | | |
|-------------------------|-------------------------|-------|-------|
| | 2016 | 2015 | 2014 |
| Volatility | 37% | 30% | 45% |
| Dividend yield | — | — | — |
| Life (in years) | 0.50 | 0.50 | 0.50 |
| Risk-free interest rate | 0.42% | 0.12% | 0.08% |

NOTE J – Income Taxes

The provision for income taxes was as follows (in thousands):

| | Year Ended December 31, | | |
|----------|-------------------------|----------------|----------------|
| | 2016 | 2015 | 2014 |
| Current | | | |
| Federal | \$3,684 | \$2,066 | \$ 43 |
| State | 555 | 289 | 254 |
| Foreign | 599 | 119 | 80 |
| Deferred | | | |
| Federal | (988) | 103 | 1,183 |
| State | (133) | (141) | (152) |
| Foreign | (577) | — | — |
| | <u>\$3,140</u> | <u>\$2,436</u> | <u>\$1,408</u> |

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A reconciliation of the expected federal income tax at the statutory rate to the provision for income taxes was as follows (in thousands):

| | Year Ended December 31, | | |
|---|-------------------------|----------------|----------------|
| | 2016 | 2015 | 2014 |
| Expected federal income tax at statutory rate | \$3,011 | \$2,404 | \$1,398 |
| State income taxes, net of federal tax effect | 320 | 246 | 124 |
| Tax impact of foreign activity | (115) | 39 | 37 |
| Permanent book/tax differences | 372 | 67 | 173 |
| Change in valuation allowance | (35) | (27) | (88) |
| Change in state deferred rate | (67) | (118) | (9) |
| Research and development credit | (261) | (200) | (178) |
| Other | (85) | 25 | (49) |
| Total provision for income taxes | \$3,140 | \$2,436 | \$1,408 |

The significant components of our deferred tax assets (liabilities) were as follows (in thousands):

| | December 31, | |
|---|-----------------|-----------------|
| | 2016 | 2015 |
| Deferred tax assets | | |
| Net operating loss and credit carryforwards | \$ 4,614 | \$4,687 |
| Deferred operations | 799 | 1,443 |
| Stock-based compensation expense | 4,085 | 3,284 |
| Depreciation and amortization | — | 1,179 |
| Accounts receivable allowances | 363 | 252 |
| Accrued expenses | 2,704 | 1,137 |
| Other | 297 | 234 |
| Gross deferred tax asset | 12,862 | 12,216 |
| Less: valuation allowance | (649) | (928) |
| Total net deferred tax asset | 12,213 | 11,288 |
| Deferred tax liability | | |
| Foreign operations | (350) | (139) |
| Depreciation and amortization | (1,328) | — |
| Total deferred tax liability | (1,678) | (139) |
| Net deferred tax assets | \$10,535 | \$11,149 |

As of December 31, 2016, we had net operating loss carryforwards of \$70.7 million for U.S. federal tax purposes. We also had \$19.2 million of various state net operating loss carryforwards. The loss carryforwards for federal tax purposes will expire between 2019 and 2036 if not utilized. The loss carryforwards for state tax purposes will expire between 2017 and 2036 if not utilized.

Section 382 of the U.S. Internal Revenue Code generally imposes an annual limitation on the amount of net operating loss carryforwards that might be used to offset taxable income when a corporation has undergone significant changes in stock ownership. We have performed a Section 382 analysis for the time period from our inception through December 8, 2010. During this time period it was determined that we had six separate ownership changes under Section 382. We have not updated the Section 382 analysis subsequent to December 8, 2010; however, we believe there have not been any events subsequent to that date that would materially impact the analysis. We believe that approximately \$17.6 million of federal losses will expire unused due to Section 382 limitations. The maximum annual limitation of federal net operating losses under Section 382 is approximately \$990,000. This limitation could be further restricted if any ownership changes occur in future years.

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Our federal and state net operating losses at December 31, 2016 included \$46.2 million and \$10.7 million, respectively, of income tax deductions in excess of previously recorded tax benefits. Although these additional tax deductions are included in the net operating losses referenced above, the related tax benefit will not be recognized until the deductions reduce our income taxes payable. The tax benefit of these excess deductions will be reflected as a credit to additional paid in capital when recognized. Accordingly, our deferred tax assets are reported net of the excess tax deductions for stock compensation and Section 382 limitations.

As of December 31, 2016 we had federal research and development credit carryforwards, net of Section 383 limitations, of \$980,000, which, if not utilized, will begin to expire in 2030. We had state research and development credit carryforwards of \$461,000, which, if not utilized, will begin to expire in 2025.

As of December 31, 2016, we had a valuation allowance against our deferred tax assets of \$649,000. The valuation allowance is established for state net operating loss and credit carryforwards that we do not expect to utilize based on our current expectations of future state taxable income.

We are subject to income taxes in the U.S. federal and various state and international jurisdictions. We are generally subject to U.S. federal and state tax examinations for all prior tax years due to our net operating loss carryforwards and the utilization of the carryforwards in years still open under statute.

As of December 31, 2016, we do not have any unrecognized tax benefits. It is our practice to recognize interest and penalties accrued on any unrecognized tax benefits as a component of income tax expense. We do not expect any material changes in our unrecognized tax positions over the next 12 months.

NOTE K – Net Income Per Share

The following table presents the components of the computation of basic and diluted net income per share for the periods indicated (in thousands, except per share amounts):

| | Year Ended December 31, | | |
|---|-------------------------|---------------|---------------|
| | 2016 | 2015 | 2014 |
| Numerator | | | |
| Net income | \$ 5,710 | \$ 4,639 | \$ 2,704 |
| Denominator | | | |
| Weighted average common shares outstanding, basic | 16,947 | 16,565 | 16,236 |
| Options to purchase common stock | 267 | 437 | 535 |
| Restricted stock units | 27 | 27 | 42 |
| Employee stock purchase plan | — | 3 | 1 |
| Weighted average common shares outstanding, diluted | <u>17,241</u> | <u>17,032</u> | <u>16,814</u> |
| Net income per share | | | |
| Basic | \$ 0.34 | \$ 0.28 | \$ 0.17 |
| Diluted | \$ 0.33 | \$ 0.27 | \$ 0.16 |

For the years ended December 31, 2016, 2015, and 2014, the effect of approximately 5,000, 4,000 and 126,000 outstanding potential common shares, respectively, were excluded from the calculation of diluted net income per share because they were anti-dilutive.

NOTE L – Retirement Savings Plan

We sponsor a 401(k) retirement savings plan for our U.S. employees. Employees can contribute up to 100% of their compensation, subject to the limits established by law. We match 25% of the employee's contribution up to the first 6% of pre-tax annual compensation. Additionally, we make statutory contributions to retirement plans

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as required by local foreign government regulations. Our contributions to the plans, which vest immediately, were \$1.4 million, \$1.1 million and \$733,000 for the years ended December 31, 2016, 2015 and 2014, respectively.

NOTE M – Related Party Transactions

SPS Commerce Foundation (the “Foundation”) is a Minnesota non-profit organization exempt from federal taxation under Section 501(c)(3) of the Internal Revenue Code. The Foundation was formed in 2015 to engage in, advance, support, promote and administer charitable activities. The directors of the Foundation are also our officers. These officers receive no compensation from the Foundation for the management services performed for the Foundation. The Foundation is not a subsidiary of ours and the financial results of the Foundation are not consolidated with our financial statements. We made contributions of \$250,000 and \$500,000 to the Foundation for the years ended 2016 and 2015, respectively. We have no current legal obligations for future commitments to the Foundation.

NOTE N – Selected Quarterly Financial Data (Unaudited)

The following table presents our selected unaudited quarterly statements of comprehensive income data (in thousands, except per share amounts):

| 2016 | For the Three Months Ended | | | |
|----------------------------|----------------------------|----------|----------|----------|
| | Mar 31 | Jun 30 | Sep 30 | Dec 31 |
| Revenues | \$45,599 | \$47,351 | \$49,284 | \$51,061 |
| Gross profit | 30,718 | 31,379 | 33,113 | 33,739 |
| Income from operations | 1,314 | 880 | 2,670 | 2,653 |
| Net income | 1,044 | 352 | 2,509 | \$ 1,805 |
| Diluted earnings per share | \$ 0.06 | \$ 0.02 | \$ 0.14 | \$ 0.10 |

| 2015 | For the Three Months Ended | | | |
|----------------------------|----------------------------|----------|----------|----------|
| | Mar 31 | Jun 30 | Sep 30 | Dec 31 |
| Revenues | \$36,970 | \$38,846 | \$40,354 | \$42,348 |
| Gross profit | 25,398 | 26,511 | 27,654 | 28,912 |
| Income from operations | 922 | 1,027 | 2,260 | 2,814 |
| Net income | 586 | 651 | 1,270 | 2,132 |
| Diluted earnings per share | \$ 0.03 | \$ 0.04 | \$ 0.07 | \$ 0.12 |

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Item 9. Changes in and Disagreements With Accountants on Accounting and Financial Disclosure

None.

Item 9A. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

We evaluated the effectiveness of the design and operation of our disclosure controls and procedures as of December 31, 2016, the end of the period covered by this Annual Report on Form 10-K. This evaluation was done under the supervision and with the participation of management, including our Chief Executive Officer (“CEO”) and Chief Financial Officer (“CFO”). Disclosure controls and procedures means controls and other procedures that are designed to provide reasonable assurance that information required to be disclosed in the reports that we file or submit under the Securities and Exchange Act of 1934, as amended (the “Exchange Act”), such as this Annual Report on Form 10-K, is recorded, processed, summarized and reported within the time periods specified in the rules and forms of the Securities and Exchange Commission (“SEC”). Disclosure controls and procedures include, without limitation, controls and procedures designed such that information is accumulated and communicated to our management, including our CEO and CFO, as appropriate to allow timely decisions regarding required disclosure. Based on this evaluation, our CEO and CFO have concluded that as of December 31, 2016, our disclosure controls and procedures were effective.

Management’s Annual Report on Internal Control Over Financial Reporting

Our management is responsible for establishing and maintaining adequate internal control over financial reporting. Internal control over financial reporting is defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act as a process designed by, or under the supervision of, our principal executive and principal financial officer and effected by our board of directors, management and other personnel, 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 and includes those policies and procedures that:

- pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of our assets;
- provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that our receipts and expenditures are being made only in accordance with authorizations of our management and directors; and
- provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of our assets that could have a material effect on our financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Under the supervision and with the participation of management, including our principal executive and financial officers, we assessed our internal control over financial reporting as of December 31, 2016, based on criteria for effective internal control over financial reporting established in *Internal Control — Integrated Framework (2013)* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Based on this assessment, management concluded that we maintained effective internal control over financial reporting as of December 31, 2016 based on the specified criteria.

In the first quarter of 2016, we acquired all outstanding common stock of Toolbox Solutions, Inc. (“Toolbox Solutions”). Toolbox Solutions represented approximately four percent of our total consolidated assets and four

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percent of our consolidated revenues as of and for the year ended December 31, 2016. As the acquisition occurred in 2016, the scope of our assessment of the effectiveness of internal control over financial reporting does not include Toolbox Solutions. This exclusion is in accordance with the SEC's general guidance that an assessment of a recently acquired business may be omitted from the assessment of the effectiveness of internal control over financial reporting in the year of acquisition.

The effectiveness of our internal control over financial reporting as of December 31, 2016 has been audited by KPMG LLP, our independent registered public accounting firm, as stated in their report, which is included under Item 8 of this Annual Report on Form 10-K.

Changes in Internal Control over Financial Reporting

There were no changes in our internal control over financial reporting during the most recent fiscal quarter ended December 31, 2016 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting. We acquired Toolbox Solutions on January 5, 2016, and as part of the ongoing integration activities, we will complete an assessment of existing controls and incorporate our controls and procedures into the acquired operations, as appropriate.

Item 9B. Other Information

None.

PART III

Item 10. Directors, Executive Officers and Corporate Governance

The information required by this item with respect to executive officers is contained in Item 1 of this Annual Report on Form 10-K under the heading "Executive Officers" and with respect to other information relating to our directors and executive officers will be set forth in our 2017 Proxy Statement under the caption "Item 1 — Election of Directors," which will be filed no later than 120 days after the end of the fiscal year covered by this Annual Report on Form 10-K, and is incorporated herein by reference.

The information required by this item under Item 405 of Regulation S-K is incorporated herein by reference to the section titled "Section 16(a) Beneficial Ownership Reporting Compliance" of our 2017 Proxy Statement, which will be filed no later than 120 days after the end of the fiscal year covered by this Annual Report on Form 10-K.

The information required by this item under Item 407(d)(4) and (d)(5) of Regulation S-K is incorporated herein by reference to the section titled "Information Regarding the Board of Directors and Corporate Governance — Board Committees — Audit Committee" of our 2017 Proxy Statement, which will be filed no later than 120 days after the end of the fiscal year covered by this Annual Report on Form 10-K.

We have adopted a code of business conduct applicable to our directors, officers (including our principal executive officer and principal financial officer) and employees. The Code of Conduct is available on our website at www.spscommerce.com under the Investor Relations section. We plan to post on our website at the address described above any future amendments or waivers of our Code of Conduct.

Item 11. Executive Compensation

The information required by this item is incorporated herein by reference to the sections titled "Executive Compensation," and "Certain Relationships and Related Transactions — Compensation Committee Interlocks and Insider Participation" of our 2017 Proxy Statement, which will be filed no later than 120 days after the end of the fiscal year covered by this Annual Report on Form 10-K.

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Item 12. *Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters*

The information related to security ownership required by this item is incorporated herein by reference to the section titled “Security Ownership” of our 2017 Proxy Statement, which will be filed no later than 120 days after the end of the fiscal year covered by this Annual Report on Form 10-K.

The information related to our equity compensation plans required by this item is incorporated herein by reference to the section titled “Executive Compensation — Outstanding Equity Awards” of our 2017 Proxy Statement, which will be filed no later than 120 days after the end of the fiscal year covered by this Annual Report on Form 10-K.

Item 13. *Certain Relationships and Related Transactions, and Director Independence*

The information required by this item is incorporated herein by reference to the sections titled “Certain Relationships and Related Transactions,” and “Information Regarding the Board of Directors and Corporate Governance — Director Independence” of our 2017 Proxy Statement, which will be filed no later than 120 days after the end of the fiscal year covered by this Annual Report on Form 10-K.

Item 14. *Principal Accounting Fees and Services*

The information required by this item is incorporated herein by reference to the section titled “Audit Committee Report and Payment of Fees to Our Independent Auditor” of our 2017 Proxy Statement, which will be filed no later than 120 days after the end of the fiscal year covered by this Annual Report on Form 10-K.

PART IV

Item 15. *Exhibits, Financial Statement Schedules*

The following documents are filed as a part of this Annual Report on Form 10-K:

- (a) Financial Statements: The financial statements filed as a part of this report are listed in Part II, Item 8.
- (b) Financial Statement Schedules: The schedules are either not applicable or the required information is presented in the consolidated financial statements or notes thereto.
- (c) Exhibits: The exhibits incorporated by reference or filed as a part of this Annual Report on Form 10-K are listed in the Exhibit Index immediately following the signatures to this report.

Item 16. *Form 10-K Summary*

None.

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.

Dated: February 27, 2017

SPS COMMERCE, INC.

By: /s/ ARCHIE C. BLACK
Archie C. Black
President and Chief Executive Officer

Each of the undersigned hereby appoints Archie C. Black and Kimberly K. Nelson, and each of them (with full power to act alone), as attorneys and agents for the undersigned, with full power of substitution, for and in the name, place and stead of the undersigned, to sign and file with the Securities and Exchange Commission under the Securities Exchange Act of 1934, any and all amendments and exhibits to this annual report on Form 10-K and any and all applications, instruments, and other documents to be filed with the Securities and Exchange Commission pertaining to this annual report on Form 10-K or any amendments thereto, with full power and authority to do and perform any and all acts and things whatsoever requisite and necessary or desirable. Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities indicated on February 27, 2017.

| <u>Name and Signature</u> | <u>Title</u> |
|---|--|
| <u>/s/ ARCHIE C. BLACK</u> Archie C. Black | <i>Chief Executive Officer, President and Director (principal executive officer)</i> |
| <u>/s/ KIMBERLY K. NELSON</u> Kimberly K. Nelson | <i>Executive Vice President and Chief Financial Officer (principal financial and accounting officer)</i> |
| <u>/s/ MARTIN J. LEESTMA</u> Martin J. Leestma | <i>Director</i> |
| <u>/s/ JAMES B. RAMSEY</u> James B. Ramsey | <i>Director</i> |
| <u>/s/ TAMI L. RELLER</u> Tami L. Reller | <i>Director</i> |
| <u>/s/ MICHAEL A. SMERKLO</u> Michael A. Smerklo | <i>Director</i> |
| <u>/s/ PHILIP E. SORAN</u> Philip E. Soran | <i>Director</i> |
| <u>/s/ SVEN A. WEHRWEIN</u> Sven A. Wehrwein | <i>Director</i> |

EXHIBIT INDEX

| <u>Exhibit Number</u> | <u>Exhibit Description</u> | <u>Incorporated By Reference</u> | | | <u>Exhibit Number</u> | <u>Filed Herewith</u> |
|---------------------------|--|----------------------------------|--------------------|-------------------------------------|---------------------------|---------------------------|
| | | <u>Form</u> | <u>File Number</u> | <u>Date of First Filing</u> | | |
| 3.1 | Amended and Restated Certificate of Incorporation | S-3 | 333-182097 | 06/13/2012 | 4.1 | |
| 3.2 | Amended and Restated Bylaws | S-1/A | 333-163476 | 03/05/2010 | 3.2 | |
| 10.1 | 2001 Stock Option Plan** | S-1/A | 333-163476 | 01/11/2010 | 10.3 | |
| 10.2 | Form of Incentive Stock Option Agreement under 2001 Stock Option Plan** | S-1/A | 333-163476 | 01/11/2010 | 10.4 | |
| 10.3 | Form of Non-Statutory Stock Option Agreement (Director) under 2001 Stock Option Plan** | S-1/A | 333-163476 | 01/11/2010 | 10.5 | |
| 10.4 | 2010 Equity Incentive Plan, as amended effective October 29, 2014** | 10-K | 001-34702 | 02/20/2015 | 10.6 | |
| 10.5 | Form of Incentive Stock Option Agreement under 2010 Equity Incentive Plan** | 8-K | 001-34702 | 02/17/2012 | 10.2 | |
| 10.6 | Form of Non-Statutory Stock Option Agreement (Employee) under 2010 Equity Incentive Plan** | 8-K | 001-34702 | 02/17/2012 | 10.3 | |
| 10.7 | Form of Non-Statutory Stock Option Agreement (Director) under 2010 Equity Incentive Plan** | 8-K | 001-34702 | 02/17/2012 | 10.4 | |
| 10.8 | Form of Restricted Stock Unit Award Agreement under 2010 Equity Incentive Plan** | 8-K | 001-34702 | 02/17/2012 | 99.2 | |
| 10.9 | Form of Restricted Stock Award Agreement under 2010 Equity Incentive Plan** | 10-Q | 001-34702 | 05/08/2012 | 10.6 | |
| 10.10 | Form of Performance Stock Unit Agreement under 2010 Equity Incentive Plan** | 8-K | 001-34702 | 02/15/2017 | 99.1 | |
| 10.11 | Non-Employee Director Compensation Policy** | | | | | X |
| 10.12 | Form of Indemnification Agreement for Independent Directors | S-1/A | 333-163476 | 01/11/2010 | 10.18 | |
| 10.13 | Form of Indemnification Agreement for Archie C. Black** | S-1/A | 333-163476 | 01/11/2010 | 10.19 | |
| 10.14 | Employment Agreement between the Company and Archie C. Black** | S-1/A | 333-163476 | 03/05/2010 | 10.20 | |
| 10.15 | Form of Executive Severance and Change in Control Agreement** | S-K | 001-34702 | 02/03/2016 | 10.1 | |
| 10.16 | Standard Form Office Lease, dated as of February 14, 2012, by and between the registrant and CSDV-MN Limited Partnership | 8-K | 001-34702 | 02/17/2012 | 10.1 | |

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| <u>Exhibit Number</u> | <u>Exhibit Description</u> | <u>Incorporated By Reference</u> | | | <u>Filed Herewith</u> | |
|---------------------------|--|----------------------------------|--------------------|-------------------------------------|---------------------------|---------------------------|
| | | <u>Form</u> | <u>File Number</u> | <u>Date of First Filing</u> | | <u>Exhibit Number</u> |
| 10.17 | Management Incentive Plan** | 8-K | 001-34702 | 02/03/2016 | 10.2 | |
| 21.1 | Subsidiaries of the registrant | | | | | X |
| 23.1 | Consent of KPMG LLP | | | | | X |
| 24.1 | Power of Attorney (included on signature page) | | | | | X |
| 31.1 | Certification of Principal Executive Officer pursuant to Rules 13a-14(a) under the Securities Exchange Act of 1934, as amended | | | | | X |
| 31.2 | Certification of Principal Financial Officer pursuant to Rules 13a-14(a) under the Securities Exchange Act of 1934, as amended | | | | | X |
| 32.1 | Certification of Chief Executive Officer and Chief Financial Officer pursuant to 18 U.S.C. Sec. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 | | | | | X |
| 101 | Interactive Data Files Pursuant to Rule 405 of Regulation S-T | | | | | X |

** Indicates management contract or compensatory plan or arrangement.

SPS COMMERCE, INC.
NON-EMPLOYEE DIRECTOR COMPENSATION PLAN

Adopted: March 10, 2016

Director annual retainer: Annual retainer, payable in case, of \$31,000 per director except for the chairperson who shall receive \$45,000

Committee chairs annual retainer: Annual retainers, payable in cash, of:

| | |
|--------------------------------------|----------|
| Audit Committee: | \$17,000 |
| Compensation Committee: | 10,000 |
| Governance and Nominating Committee: | 7,000 |

Committee member annual retainer: Annual retainers, payable in cash, of:

| | |
|--------------------------------------|---------|
| Audit Committee: | \$7,000 |
| Compensation Committee: | 5,000 |
| Governance and Nominating Committee: | 3,000 |

Annual non-statutory stock option grants:

- To purchase up to \$53,000 of common stock calculated as the grant date fair value of the stock-based awards computed in accordance with FASB ASC 718 on the date of the Company's annual meeting of stockholders using the closing sale price for a share of the Company's common stock on the Nasdaq Global Market on the date of the annual meeting of stockholders
- Granted to directors who are elected to the board at the annual meeting of stockholders
- Exercise price per share equal to the closing sales price for a share on the Nasdaq Global Market on the date of the annual meeting of stockholders
- Vest in four equal installments on the last day of each fiscal quarter with the first vesting occurring on June 30, provided the recipient remains a member of the board as of the vesting date
- Maximum term of seven years measured from the date of grant

Annual restricted stock grants:

- To acquire up to \$53,000 of restricted common stock calculated by dividing this amount by the closing sale price for a share of the Company's common stock on the Nasdaq Global Market on the date of the Company's annual meeting of stockholders
- Granted to directors who are elected to the board at the annual meeting of stockholders
- Vests in four equal installments on the last day of each fiscal quarter with the first vesting occurring on June 30, provided the recipient remains a member of the board as of the vesting date

Reimbursement of expenses: The Company shall reimburse directors for reasonable expenses incurred in connection with attending board and committee meetings.

Initial non-statutory stock option grants: Each director receives a non-statutory stock option grant to purchase up to \$111,000 of common stock calculated as the grant date fair value of the stock-based awards computed in accordance with FASB ASC 718 in connection with initial appointment or election to the board. The grant is made on the date of initial appointment or election to the board. Exercise price per share equal to the closing sales price for a share on the Nasdaq Global Market on the effective date of the appointment or election of the director. Vest in equal monthly installments commencing on the first day of the calendar month following the initial appointment or election to the board, provided the recipient remains a member of the board as of the vesting date. Maximum term of seven years measured from the date of grant.

List of SPS Commerce, Inc. Subsidiaries

| Name of Company | State or Other Jurisdiction of Incorporation/Organization |
|--------------------------------|--|
| SPS Commerce Australia Pty Ltd | Australia |
| SPS Commerce Hong Kong Limited | Hong Kong |
| SPS International, Inc. | Delaware |
| SPS Europe Limited | England and Wales |
| Edifice Japan G.K. | Japan |
| SPS Ukraine LLC | Ukraine |
| SPS Commerce Canada, Ltd. | Ontario |

Consent of Independent Registered Public Accounting Firm

The Board of Directors
SPS Commerce, Inc.:

We consent to the incorporation by reference in the registration statements on Form S-3 (No. 333-192392, 333-182097 and 333-174026) and on Form S-8 (Nos. 333-209721, 333-201673, 333-193544, 333-185972, 333-182007, 333-179236, 333-172073, 333-167315 and 333-167314) of SPS Commerce, Inc. of our report dated February 27, 2017, with respect to the consolidated balance sheets of SPS Commerce, Inc. and subsidiaries as of December 31, 2016 and 2015, and the related consolidated statements of comprehensive income, stockholders' equity, and cash flows for the each of the years in the three-year period ended December 31, 2016, and the effectiveness of internal control over financial reporting as of December 31, 2016, which report appears in the December 31, 2016 annual report on Form 10-K of SPS Commerce, Inc.

Our report dated February 27, 2017 on internal control over financial reporting as of December 31, 2016, contains an explanatory paragraph that states management excluded from its assessment of the effectiveness of internal control over financial reporting as of December 31, 2016, Toolbox Solutions, Inc.'s ("Toolbox") internal control over financial reporting associated with approximately four percent of total assets and four percent of revenues in the consolidated financial statements of SPS Commerce, Inc. as of and for the year ended December 31, 2014. Our audit of internal control over financial reporting of SPS Commerce, Inc. also excluded an evaluation of the internal control over financial reporting of Toolbox.

/s/ KPMG LLP

Minneapolis, Minnesota
February 27, 2017

CERTIFICATION PURSUANT TO SECTION 302 OF THE SARBANES-OXLEY ACT

I, Archie C. Black, certify that:

1. I have reviewed this Annual Report on Form 10-K of SPS Commerce, Inc.;
2. Based on my knowledge, this 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 report;
3. Based on my knowledge, the financial statements, and other financial information included in this 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 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 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 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.

/s/ ARCHIE C. BLACK

Archie C. Black
President and Chief Executive Officer
(principal executive officer)
February 27, 2017

CERTIFICATION PURSUANT TO SECTION 302 OF THE SARBANES-OXLEY ACT

I, Kimberly K. Nelson, certify that:

1. I have reviewed this Annual Report on Form 10-K of SPS Commerce, Inc.;
2. Based on my knowledge, this 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 report;
3. Based on my knowledge, the financial statements, and other financial information included in this 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 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 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 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.

/s/ KIMBERLY K. NELSON

Kimberly K. Nelson

*Executive Vice President and Chief Financial Officer
(principal financial and accounting officer)*

February 27, 2017

**CERTIFICATION PURSUANT TO
18 U.S.C. §1350
AS ADOPTED PURSUANT TO
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

In connection with the Annual Report on Form 10-K of SPS Commerce, Inc. (the "Company") for the period ended December 31, 2016, as filed with the Securities and Exchange Commission on the date hereof (the "Report"), the undersigned, the Chief Executive Officer and the Chief Financial Officer of the Company, hereby certify, pursuant to and for purposes of 18 U.S.C. §1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, 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/ ARCHIE C. BLACK

Archie C. Black
President and Chief Executive Officer

/s/ KIMBERLY K. NELSON

Kimberly K. Nelson
Executive Vice President and Chief Financial Officer

February 27, 2017

