Accretive Health, Inc.
Form 10-Q
November 02, 2016

UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
Form 10-Q

(Mark One)

þ QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended September 30, 2016
OR
o 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: 001-34746
ACCRETIVE HEALTH, INC.
(Exact name of registrant as specified in its charter)

| | |
|---|---|
| Delaware | 02-0698101 |
| (State or other jurisdiction of incorporation or organization) | (I.R.S. Employer Identification Number) |
| 401 North Michigan Avenue Suite 2700 Chicago, Illinois | 60611 |
| (Address of principal executive offices) | (Zip code) |

(312) 324-7820
(Registrant's telephone number, including area code)
Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.  Yes þ     No ¨
Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).  Yes þ    No  ¨
Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

| | | | |
|---|---|---|---|
| Large accelerated filer o | Accelerated filer þ | Non-accelerated filer o<br>(Do not check if a smaller reporting company) | Smaller reporting company o |

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).  Yes o     No R
As of October 31, 2016, the registrant had 106,775,458 shares of common stock, par value $0.01 per share, outstanding.

Accretive Health, Inc.
FORM 10-Q

For the period ended September 30, 2016
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PART I — FINANCIAL INFORMATION

ITEM 1. CONSOLIDATED FINANCIAL STATEMENTS

Accretive Health, Inc.
Condensed Consolidated Balance Sheets
(In thousands, except share and per share data)

| | September 30, 2016 (Unaudited) | December 31, 2015 |
|---|---|---|
| Assets | | |
| Current assets: | | |
| Cash and cash equivalents | $ 201,947 | $ 103,497 |
| Short-term investments | — | 1,023 |
| Accounts receivable, net | 8,904 | 10,194 |
| Prepaid income taxes | 856 | 1,102 |
| Other current assets | 16,024 | 10,924 |
| Total current assets | 227,731 | 126,740 |
| Property, equipment and software, net | 30,082 | 27,217 |
| Non-current deferred tax assets | 184,270 | 300,825 |
| Restricted cash equivalents | 1,500 | 1,500 |
| Other assets | 6,692 | 4,007 |
| Total assets | $ 450,275 | $ 460,289 |
| Liabilities and stockholders' equity (deficit) | | |
| Current liabilities: | | |
| Accounts payable | $ 3,888 | $ 5,306 |
| Current portion of customer liabilities | 71,582 | 202,516 |
| Current portion of customer liabilities - related party | 124,072 | — |
| Accrued compensation and benefits | 17,397 | 9,062 |
| Other accrued expenses | 17,123 | 15,743 |
| Total current liabilities | 234,062 | 232,627 |
| Non-current portion of customer liabilities | 750 | 432,477 |
| Non-current portion of customer liabilities - related party | 62,835 | — |
| Other non-current liabilities | 10,152 | 8,498 |
| Total liabilities | 307,799 | 673,602 |
| 8.00% Series A convertible preferred stock: par value $0.01 per share, 204,040 shares issued and outstanding as of September 30, 2016; no shares authorized or issued as of December 31, 2015 (aggregate liquidation value of $210,160 as of September 30, 2016) | 167,389 | — |
| Stockholders' equity (deficit): | | |
| Common stock, $0.01 par value, 500,000,000 shares authorized,116,386,064 shares issued and 106,816,919 shares outstanding at September 30, 2016; 113,259,408 shares issued and 107,715,436 shares outstanding at December 31, 2015 | 1,164 | 1,133 |
| Additional paid-in capital | 348,980 | 322,492 |
| Accumulated deficit | (317,828) | (481,773) |
| Accumulative other comprehensive loss | (2,540) | (2,488) |
| Treasury stock | (54,689) | (52,677) |
| Total stockholders' equity (deficit) | (24,913) | (213,313) |
| Total liabilities and stockholders’ equity (deficit) | $ 450,275 | $ 460,289 |

See accompanying notes to condensed consolidated financial statements

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Accretive Health, Inc.
Condensed Consolidated Statements of Operations and Comprehensive Income (Loss)
(In thousands, except share and per share data)

| | | | | |
|---|---|---|---|---|
| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
| | 2016 | 2015 | 2016 | 2015 |
| | (unaudited) | | (unaudited) | |
| Net services revenue ($343.4 million and $0 million from related party for the nine months ended September 30, 2016 and September 30, 2015, respectively. $22.7 million and $0 million from related party for the three months ended September 30, 2016 and September 30, 2015, respectively. ) | $125,535 | $15,842 | $486,400 | $48,898 |
| Operating expenses: | | | | |
| Costs of services | 47,376 | 45,326 | 137,618 | 130,284 |
| Selling, general and administrative | 16,201 | 21,395 | 58,397 | 59,726 |
| Other | 536 | 3,964 | 19,993 | 5,850 |
| Total operating expenses | 64,113 | 70,685 | 216,008 | 195,860 |
| Income (loss) from operations | 61,422 | (54,843) | 270,392 | (146,962) |
| Net interest income | 57 | 73 | 187 | 147 |
| Income (loss) before income tax provision | 61,479 | (54,770) | 270,579 | (146,815) |
| Income tax provision (benefit) | 24,146 | (21,800) | 106,634 | (57,112) |
| Net income (loss) | $37,333 | $(32,970) | $163,945 | $(89,703) |
| | | | | |
| Net income (loss) per common share: | | | | |
| Basic | $0.18 | $(0.34) | $0.62 | $(0.93) |
| Diluted | $0.18 | $(0.34) | $0.62 | $(0.93) |
| Weighted average shares used in calculating net income (loss) per common share: | | | | |
| Basic | 100,934,561 | 97,230,069 | 99,870,685 | 96,358,342 |
| Diluted | 102,176,280 | 97,230,069 | 101,018,450 | 96,358,342 |
| Consolidated statements of comprehensive income (loss): | | | | |
| Net income (loss) | 37,333 | (32,970) | 163,945 | (89,703) |
| Other comprehensive income (loss): | | | | |
| Foreign currency translation adjustments | 192 | (429) | (52) | (702) |
| Comprehensive income (loss) | $37,525 | $(33,399) | $163,893 | $(90,405) |
| | | | | |
| Reconciliation of net income (loss) to income (loss) available to common shareholders: | | | | |
| Basic: | | | | |
| Net income (loss) | $37,333 | $(32,970) | $163,945 | $(89,703) |
| Less dividends on preferred shares | (4,120) | — | (58,480) | — |
| Less income allocated to preferred shareholders | (15,092) | — | (43,423) | — |
| Net income (loss) available/allocated to common shareholders - basic | $18,121 | $(32,970) | $62,042 | $(89,703) |
| Diluted: | | | | |
| Net income (loss) | $37,333 | $(32,970) | $163,945 | $(89,703) |
| Less dividends on preferred shares | (4,120) | — | (58,480) | — |
| Less income allocated to preferred shareholders | (14,991) | — | (43,132) | — |
| Net income (loss) available/allocated to common shareholders - diluted | $18,222 | $(32,970) | $62,333 | $(89,703) |

See accompanying notes to condensed consolidated financial statements

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Accretive Health, Inc.
Condensed Consolidated Statements of Stockholders' Equity (Deficit) (unaudited)
(In thousands, except per share data)

| | Common Stock | | Treasury Stock | | Additional Paid-In Capital | Accumulated Deficit | Accumulated other comprehensive income (loss) | Total |
|---|---|---|---|---|---|---|---|---|
| | Shares | Amount | Shares | Amount | | | | |
| Balance at December 31, 2015 | 113,259,408 | $ 1,133 | (5,543,972) | $ (52,677) | $ 322,492 | $ (481,773) | $ (2,488) | $ (213,313) |
| Share-based compensation expense | — | — | — | — | 25,173 | — | — | 25,173 |
| Deferred tax asset write off including shortfall of $3,434 | — | — | — | — | (10,021) | — | — | (10,021) |
| Issuance of common stock related to share-based compensation plans | 3,071,876 | 31 | — | — | (31) | — | — | — |
| Exercise of vested stock options | 54,780 | — | — | — | 88 | — | — | 88 |
| Beneficial conversion feature | — | — | — | — | 48,320 | | — | 48,320 |
| Issuance of stock warrants | — | — | — | — | 21,440 | — | — | 21,440 |
| Dividends paid/accrued dividends | — | — | — | — | (10,161) | — | — | (10,161) |
| Deemed preferred stock dividend | — | — | — | — | (48,320) | — | — | (48,320) |
| Treasury stock purchases | — | — | (4,025,173) | (2,012) | — | — | — | (2,012) |
| Foreign currency translation adjustments | — | — | — | — | — | — | (52) | (52) |
| Net income (loss) | — | — | — | — | — | 163,945 | — | 163,945 |
| Balance at September 30, 2016 | 116,386,064 | $ 1,164 | (9,569,145) | $ (54,689) | $ 348,980 | $ (317,828) | $ (2,540) | $ (24,913) |

See accompanying notes to condensed consolidated financial statements.

Accretive Health, Inc.
Condensed Consolidated Statements of Cash Flows
(In thousands)

| | Nine Months Ended September 30, 2016 (Unaudited) | 2015 |
|---|---|---|
| Operating activities: | | |
| Net income (loss) | $ 163,945 | $ (89,703) |
| Adjustments to reconcile net income (loss) to net cash provided by (used in) operations: | | |
| Depreciation and amortization | 7,305 | 6,556 |
| Share-based compensation | 25,173 | 22,974 |
| Provision/(Recoveries) for doubtful receivables | 87 | (79) |
| Deferred income taxes | 106,548 | (58,567) |
| Excess tax benefits from share-based awards | — | — |
| Changes in operating assets and liabilities: | | |
| Accounts receivable | 1,203 | (621) |
| Prepaid income taxes | 216 | 632 |
| Other assets | (7,939) | (334) |
| Accounts payable | (1,416) | (6,108) |
| Accrued compensation and benefits | 8,336 | 311 |
| Other liabilities | 3,054 | (3,648) |
| Customer liabilities and customer liabilities - related party | (375,754) | 135,058 |
| Net cash provided by (used in) operating activities | (69,242) | 6,471 |
| Investing activities: | | |
| Purchases of property, equipment and software | (10,395) | (18,304) |
| Proceeds from maturation of short-term investments | 1,023 | — |
| Net cash used in investing activities | (9,372) | (18,304) |
| Financing activities: | | |
| Series A convertible preferred stock and warrant issuance, net of issuance costs | 178,669 | — |
| Exercise of vested options | 88 | 1,331 |
| Restricted cash released from letter of credit | — | 5,000 |
| Excess tax benefit from share-based awards | — | — |
| Purchase of treasury stock | (2,012) | (1,382) |

| | | | | |
|---|---|---|---|---|
| Net cash provided by financing activities | 176,745 | | 4,949 | |
| Effect of exchange rate changes on cash | 319 | | (567 | ) |
| Net increase (decrease) in cash and cash equivalents | 98,450 | | (7,451 | ) |
| Cash and cash equivalents at beginning of period | 103,497 | | 145,167 | |
| Cash and cash equivalents at end of period | $ | 201,947 | $ | 137,716 |
| | | | | |
| Supplemental disclosure of non-cash financing activities | | | | |
| Accrued dividends payable to Preferred Stockholders | $ | 6,120 | $ | — |
| Accrued liabilities related to purchases of property, equipment and software | 545 | | 348 | |
| Accounts payable related to purchases of property, equipment and software | — | | — | |

See accompanying notes to condensed consolidated financial statements

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Accretive Health, Inc.
Notes to Condensed Consolidated Financial Statements (Unaudited)

NOTE 1 — BUSINESS DESCRIPTION AND BASIS OF PRESENTATION

Business Description

Accretive Health, Inc., together with its subsidiaries (the "Company"), is a leading provider of services that help healthcare providers generate sustainable improvements in their operating margins and cash flows while also improving patient, physician and staff satisfaction for its customers. The Company achieves these results for its customers through an integrated approach encompassing an end-to-end revenue cycle management service offering and physician advisory services. The Company does so by deploying a unique operating model that leverages its extensive healthcare site experience, innovative technology and process excellence. The Company also offers modular services, allowing clients to engage the Company for only specific components of its end-to-end revenue cycle management service offering.

The Company’s primary service offering consists of revenue cycle management ("RCM"), which helps healthcare providers to more efficiently manage their revenue cycles. This encompasses patient registration, insurance and benefit verification, medical treatment documentation and coding, bill preparation and collections from patients and payers. The Company's physician advisory services ("PAS") offering assists hospitals in complying with payer requirements regarding whether to classify a hospital visit as an in-patient or an out-patient observation case for billing purposes and consists of both concurrent review and retrospective chart audits to help its customers achieve compliant and accurate billing. The Company also provides its customers with retrospective appeal management service support for both governmental and commercial payers.

In December 2015, the Company announced a long-term strategic partnership with Ascension Health Alliance, the parent of the Company's largest customer and the nation’s largest Catholic and non-profit health system, and TowerBrook Capital Partners ("TowerBrook"), an investment management firm, which transaction (the "Transaction") was completed on February 16, 2016. As part of the Transaction, the Company amended and restated its Master Professional Services Agreement ("A&R MPSA") with Ascension Health ("Ascension") effective February 16, 2016 with a term of ten years. Pursuant to the A&R MPSA and with certain limited exceptions, the Company will become the exclusive provider of RCM services and PAS with respect to acute care services provided by the hospitals affiliated with Ascension that execute supplement agreements with the Company.

Basis of Presentation

The accompanying unaudited condensed consolidated financial statements reflect the Company's financial position as of September 30, 2016, the results of operations for the three and nine months ended September 30, 2016 and 2015, and the cash flows of the Company for the nine months ended September 30, 2016 and 2015. These financial statements include the accounts of Accretive Health, Inc. and its wholly owned subsidiaries. All material intercompany amounts have been eliminated in consolidation. These financial statements have been prepared in accordance with United States generally accepted accounting principles ("GAAP") for interim financial reporting and as required by the rules and regulations of the U.S. Securities and Exchange Commission (the “SEC”). Accordingly, certain information and footnote disclosures required for complete financial statements are not included herein. In the opinion of management, all adjustments, consisting of normal recurring adjustments, considered necessary for a fair presentation of the interim financial information, have been included. Operating results for the three and nine months ended September 30, 2016, are not necessarily indicative of the results that may be expected for any other interim period or for the fiscal year ending December 31, 2016.

Accretive Health, Inc.
Notes to Condensed Consolidated Financial Statements (Unaudited) — (Continued)

When preparing financial statements in conformity with GAAP, the Company must make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues, expenses and related disclosures at the date of the financial statements. Actual results could differ from those estimates. For a more complete discussion of the Company’s significant accounting policies and other information, the unaudited condensed consolidated financial statements and notes thereto should be read in conjunction with the audited consolidated financial statements included in the Company's Annual Report on Form 10-K for the year ended December 31, 2015 (the "2015 10-K").

NOTE 2 — RECENT ACCOUNTING PRONOUNCEMENTS

From time to time, new accounting pronouncements are issued by the Financial Accounting Standards Board ("FASB") and are adopted by the Company as of the specified effective date. Unless otherwise discussed, the Company's management believes that recently issued accounting pronouncements do not have a material impact on the Company's consolidated financial position, results of operations, or cash flows, or do not apply to the Company's operations.

In May 2014, the FASB issued Accounting Standards Update ("ASU") No. 2014-09, Revenue from Contracts with Customers (Topic 606) ("ASU 2014-09"), which supersedes the revenue recognition requirements in Accounting Standard Codification 605, Revenue Recognition ("ASC 605"). ASU 2014-09 is based on the principle that revenue is recognized to depict the transfer of 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. ASU 2014-09 also requires additional disclosure about the nature, amount, timing and uncertainty of revenue and cash flows arising from customer contracts, including significant judgments and changes in judgments. ASU 2014-09 is effective for annual reporting periods beginning after December 15, 2017, including interim periods within such reporting period, with early application permitted. The Company plans to early adopt the standard, effective January 1, 2017, and to apply the standard using the cumulative effect method to contracts for which all or substantially all of the revenue has not been recognized under GAAP as of the adoption date. The Company's ability to early adopt ASU 2014-09 is dependent on the completion of its analysis of the information necessary to calculate the cumulative effect. The Company anticipates this standard will have a material impact on it consolidated financial statements. While it is continuing to assess all potential impacts of the standard, the Company believes the most significant impact will be the recognition of revenue at the time services are provided or incentive measurements are finalized, as opposed to at the time of a contractual agreement event, which is when the Company now recognizes revenue for its end-to-end revenue cycle contracts for its base and incentive fee revenues. The Company does not expect a significant impact to revenue related to its PAS offering. The Company has not yet finalized all the potential effects of the new standard on its consolidated financial statements.

In April 2015, the FASB issued ASU No. 2015-05, Customers Accounting for Fees Paid in a Cloud Computing Arrangement ("ASU 2015-05"). The Company adopted ASU 2015-05 on the required date of January 1, 2016 using the prospective method. For the nine months ended September 30, 2016, the Company did not enter into any new, material arrangements covered by this standard.

In February 2016, the FASB issued ASU No. 2016-02, Leases (Topic 842) ("ASU 2016-02"), which supersedes existing guidance on accounting for leases in Topic 840, Leases. ASU 2016-02 generally requires all leases to be recognized in the statement of financial position. The provisions of ASU 2016-02 are effective for reporting periods beginning after December 15, 2018; early adoption is permitted. The provisions of ASU 2016-02 are to be applied using a modified retrospective approach. The Company has not yet determined the potential effects of this new standard on its consolidated financial statements, if any.

In March 2016, the FASB issued ASU No. 2016-09, Compensation-Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting ("ASU 2016-09"). ASU 2016-09 simplifies the accounting for employee share-based payment transactions, including the accounting for income taxes, forfeitures, and statutory tax withholding requirements, as well as classification in the statement of cash flows. The provisions of ASU 2016-09 are effective for annual periods beginning after December 15, 2016, and interim periods within those annual periods. Early adoption is permitted for any entity in any interim or annual period. The Company is currently evaluating the impact of the adoption of this prospective guidance on its consolidated financial statements.

In August 2016, the FASB issued ASU 2016-15, Statement of Cash Flows (Topic 230): Classificaiton of Certain Cash Receipts and Cash Payments ("ASU 2016-15"). ASU 2016-15 addresses eight specific cash flow issues with the objective of reducing diversity in practice in how certain cash receipts and payments are presented and classified in the statement of cash flows. The guidance is effective for interim and annual periods beginning after December 15, 2017, and early adoption is permitted. The guidance requires application using a retrospective transition method. Upon adoption, ASU 2016-15 will result in inclusion of restricted cash in the Company's Condensed Consolidated Statements of Cash Flows.

NOTE 3 — FAIR VALUE OF FINANCIAL INSTRUMENTS

The Company has adopted the provisions of FASB Accounting Standards Codification ("ASC") Topic 820, Fair Value Measurements ("ASC 820"), which defines fair value, establishes a framework for measuring fair value in GAAP, and expands disclosures about fair value measurements. ASC 820 does not require any new fair value measurements, but provides guidance on how to measure fair value by providing a fair value hierarchy used to classify the source of the information. The fair value hierarchy distinguishes between assumptions based on market data (observable inputs) and an entity's own assumptions (unobservable inputs). The hierarchy consists of three levels:

- Level 1: Observable inputs such as quoted prices in active markets for identical assets and liabilities;
- Level 2: Inputs other than quoted prices that are observable for the asset or liability, either directly or indirectly. These include quoted prices for similar assets or liabilities in active markets and quoted prices for identical or similar assets or liabilities in markets that are not active, and model-derived valuations in which all significant inputs and significant value drivers are observable in active markets; and
- Level 3: Valuations derived from valuation techniques in which one or more significant inputs or significant value drivers are unobservable.

The carrying amounts of the Company's financial instruments, which include financial assets such as cash and cash equivalents, restricted cash equivalents, accounts receivable, amounts due from related party, short-term investments and certain other current assets, as well as financial liabilities such as accounts payable, customer liabilities, customer liabilities-related party, accrued compensation and benefits and certain other accrued expenses, approximate their fair values, due to the short-term nature of these instruments. The Company's financial assets which are required to be measured at fair value on a recurring basis consist of cash equivalents, which are short-term investments with maturity dates of less than three months and accordingly are classified as Level 1 assets in the fair value hierarchy. The Company's certificates of deposit are valued at face value, plus accrued interest, which approximates fair value, and are reported as Level 2 assets in the fair value hierarchy. The Company does not have any financial liabilities that are required to be measured at fair value on a recurring basis.

The Company's 8.00% Series A Convertible Preferred Stock, $0.01 par value per share (the "Preferred Stock"), and the Warrant (as defined in Note 10) are Level 3 financial instruments and were valued using a combination of binomial lattice and Black-Scholes models to determine the fair value allocation. The primary assumptions used in such models were expected length of time prior to conversion, and exercise of warrants, of the Preferred Stock and Warrant (5-10 years), the exercise price of the Warrant ($3.50 per share), the risk free rate over the expected time horizon (1.35% to 1.66%), the Company's common stock price as of February 16, 2016 ($2.65 per share), the expected annual volatility of the Company stock price (40%) and the market rate of preferred stock for comparable companies (9.50%).

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Accretive Health, Inc.
Notes to Condensed Consolidated Financial Statements (Unaudited) — (Continued)

NOTE 4 — ACCOUNTS RECEIVABLE AND ALLOWANCE FOR DOUBTFUL ACCOUNTS

Accounts receivable is comprised of unpaid balances pertaining to non-RCM service fees and net receivable balances for RCM customers after considering cost reimbursements owed to such customers, including related accrued balances.

The Company maintains an estimated allowance for doubtful accounts to reduce its accounts receivable to the amount that it believes will be collected. This allowance is based on the Company’s historical experience, its assessment of each customer’s ability to pay, the length of time a balance has been outstanding, input from key customer resources assigned to each customer, and the status of any ongoing operations with each applicable customer.

Movements in the allowance for doubtful accounts are as follows (in thousands):

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2016 | 2015 | 2016 | 2015 |
| | (unaudited) | | (unaudited) | |
| Beginning balance | $41 | $112 | $99 | $314 |
| (Recoveries) provision | 114 | (34) | 87 | (79) |
| Write-offs | (7) | (12) | (38) | (169) |
| Ending balance | $148 | $66 | $148 | $66 |

NOTE 5 — PROPERTY, EQUIPMENT AND SOFTWARE

Property, equipment and software consist of the following (in thousands):

| | September 30, 2016 (unaudited) | December 31, 2015 |
|---|---|---|
| Computer and other equipment | $ 21,209 | $21,348 |
| Leasehold improvements | 15,151 | 17,851 |
| Software | 25,872 | 22,302 |
| Office furniture | 4,530 | 4,888 |
| Property, equipment and software, gross | 66,762 | 66,389 |
| Less: Accumulated depreciation and amortization | (36,680) | (39,172) |
| Property, equipment and software, net | $ 30,082 | $27,217 |

The following table summarizes the allocation of depreciation and amortization expense between cost of services and selling, general and administrative expenses (in thousands):

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2016 | 2015 | 2016 | 2015 |
| | (unaudited) | | (unaudited) | |
| Cost of services | $2,545 | $2,491 | $6,872 | $5,799 |
| Selling, general and administrative | 128 | 247 | 433 | 757 |
| Total depreciation and amortization | $2,673 | $2,738 | $7,305 | $6,556 |

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Accretive Health, Inc.
Notes to Condensed Consolidated Financial Statements (Unaudited) — (Continued)

NOTE 6 — CUSTOMER LIABILITIES
Customer liabilities consist of the following (in thousands):

| | September 30, 2016 (unaudited) | December 31, 2015 |
|---|---|---|
| Deferred customer billings, current (1) | $ 151,690 | $ 130,124 |
| Accrued service costs, current (1) | 36,430 | 70,656 |
| Customer deposits, current (1) | 7,529 | 1,641 |
| Deferred revenue, current | 5 | 95 |
| Current portion of customer liabilities | 195,654 | 202,516 |
| Deferred customer billings, non-current (2) | $ 62,835 | $ 431,944 |
| Customer deposits, non-current | — | 533 |
| Deferred revenue, non-current | $ 750 | $ — |
| Non current portion of customer liabilities | $ 63,585 | $ 432,477 |
| Total customer liabilities | $ 259,239 | $ 634,993 |

(1) Includes $84.8 million, $31.8 million and $7.5 million in current deferred customer billings, accrued service costs and customer deposits, respectively, for a related party that are included in the current portion of customer liabilities - related party in the accompanying Condensed Consolidated Balance Sheets at September 30, 2016.
(2) Includes $62.8 million in deferred customer billings for a related party that are included in the non-current portion of customer liabilities - related party in the accompanying Condensed Consolidated Balance Sheets at September 30, 2016.

NOTE 7 — SHARE-BASED COMPENSATION
The share-based compensation expense relating to the Company's stock options and restricted stock awards ("RSAs") for the three months ended September 30, 2016 and 2015 was $4.8 million and $12.3 million, respectively, with related tax benefits of approximately $1.9 million and $4.5 million, respectively. The share-based compensation expense relating to the Company's stock options and RSAs for the nine months ended September 30, 2016 and 2015 was $25.3 million and $25.3 million, respectively, with related tax benefits of approximately $10.0 million and $9.6 million, respectively.
Total share-based compensation expense that has been included in the Company's consolidated statements of operations was as follows (in thousands):

| | Three Months Ended September 30, 2016 | 2015 | Nine Months Ended September 30, 2016 | 2015 |
|---|---|---|---|---|
| | (unaudited) | | (unaudited) | |
| Share-based compensation expense allocation details: | | | | |
| Cost of services | $ 1,281 | $ 3,152 | $ 4,804 | $ 5,756 |
| Selling, general and administrative | 3,479 | 9,163 | 18,639 | 19,562 |
| Other | — | — | 1,828 | — |
| Total share-based compensation expense (1) | $ 4,760 | $ 12,315 | $ 25,271 | $ 25,318 |

(1) Includes $0.1 million in share-based compensation expense paid in cash during the nine months ended September 30, 2016 and $1.9 million and $2.3 million in share-based compensation expense paid in cash during the three and

nine months ended September 30, 2015, respectively. There was no share-based compensation expense paid in cash for the three months ended September 30, 2016.

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Accretive Health, Inc.
Notes to Condensed Consolidated Financial Statements (Unaudited) — (Continued)

The Company uses the Black-Scholes option pricing model to determine the estimated fair value of each option as of its grant date. These inputs are subjective and generally require significant analysis and judgment to develop. The Company used Monte Carlo simulations to estimate the fair value of its RSAs with vesting based on market-based performance conditions as of their respective grant dates. Expected life is based on the market condition to which the vesting is tied.

The following table sets forth the significant assumptions used in the Black-Scholes option pricing model and the Monte Carlo simulations and the calculation of share-based compensation expense for the nine months ended September 30, 2016 and 2015:

| | Nine Months Ended September 30, | |
|---|---|---|
| | 2016 | 2015 |
| Future dividends | — | — |
| Risk-free interest rate | 1.2% to 1.9% | 1.5% to 2.0% |
| Expected volatility | 45% to 50% | 50% to 68% |
| Expected life | 6.25 | 6.25 |
| Forfeitures | 5.68% annually | 5.68% annually |

The risk-free interest rate input is based on U.S. Treasury instruments, and expected volatility of the share price based upon review of the historical volatility levels of the Company's common stock in conjunction with that of public companies that operate in similar industries or are similar in terms of stage of development or size and a projection of this information toward its future expected volatility. The Company used the simplified method to estimate the expected option life for 2016 and 2015 option grants. The simplified method was used due to the lack of sufficient historical data available to provide a reasonable basis upon which to estimate the expected term of each stock option.

Stock Options

A summary of the options activity during the nine months ended September 30, 2016 is shown below:

| | Shares | Weighted-Average Exercise Price |
|---|---|---|
| Outstanding at January 1, 2016 | 15,260,266 | $ 10.23 |
| Granted | 1,274,559 | 2.19 |
| Exercised | (54,780) | 1.89 |
| Canceled | (2,177,007) | 7.62 |
| Forfeited | (3,399,358) | 9.99 |
| Outstanding at September 30, 2016 | 10,903,680 | $ 9.93 |
| Outstanding and vested and exercisable at September 30, 2016 | 7,932,963 | $ 11.44 |
| Outstanding and vested and exercisable at December 31, 2015 | 8,876,517 | $ 11.63 |

Accretive Health, Inc.
Notes to Condensed Consolidated Financial Statements (Unaudited) — (Continued)

Restricted Stock Awards

A summary of the restricted stock activity during the nine months ended September 30, 2016 is shown below:

| | Shares | Weighted-Average Grant Date Fair Value |
|---|---|---|
| Outstanding at January 1, 2016 | 9,255,932 | $ 4.24 |
| Granted | 3,071,876 | 2.58 |
| Vested | (3,336,334) | 3.73 |
| Forfeited | (3,061,230) | 4.63 |
| Outstanding at September 30, 2016 | 5,930,244 | $ 3.05 |

In most cases, RSA vesting is based on the passage of time. The amount of share-based compensation expense is based on the fair value of the Company's common stock on the respective grant dates and is recognized ratably over the vesting period.

The Company's RSA agreements allow employees to surrender to the Company shares of common stock upon vesting of their RSAs in lieu of their payment of the required personal employment-related taxes. The Company does not withhold taxes in excess of minimum required statutory requirements. During the nine months ended September 30, 2016 and 2015, employees delivered to the Company 981,505 and 288,490 shares of stock, respectively, which the Company recorded at a cost of approximately $2.0 million and $1.4 million, respectively. Shares surrendered for payment of personal employment-related taxes are held in treasury.

Other Matters

During the second quarter of 2016, in connection with the resignation of the Company's Chief Executive Officer, Chief Financial Officer and restructuring plan described in Note 8 below, the vesting of certain options and RSAs was accelerated as described in the agreements previously entered into by the former employees and resulted in an increase of share-based compensation expense for the nine months ended September 30, 2016 of $7.0 million and is recorded in selling, general and administrative expenses.

During the second quarter of 2015, in connection with the resignation of a former Chief Executive Officer of the Company from the Company's board of directors (the "Board"), the Company modified the terms of awards previously granted to such Board member. This modification allowed for the continuation of vesting of options despite his resignation from the Board, and resulted in a net increase of share-based compensation expense for the nine months ended September 30, 2015 of $3.1 million and is recorded in other operating expenses.

Subsequent Events

On October 3, 2016, the Board approved an amended Long-Term Incentive (“LTI”) program for 2016 and 2017, pursuant to which 7,087,374 stock options and 1,361,794 restricted stock units were granted. and which program contemplates the issuance of approximately 3,577,780 performance-based restricted stock units ("PBRSUs"), although the actual number of PBRSUs has not been set and may be greater. The issuance of the PBRSUs remains subject to the Board establishing the performance criteria and goals and maximum target number of shares. One-half of the stock options, representing 3,543,687 shares of common stock, and all of the restricted stock units granted under the LTI program on such date were issued contingent upon stockholder approval of the amended and restatement Second Amended and and Restated 2010 Stock Incentive Plan (the "Second A&R 2010 Plan") at the Company’s 2016 annual meeting of stockholders currently planned for December 2016 (the “2016 Annual Meeting”). If stockholder approval is not obtained, such awards will be cancelled.

Accretive Health, Inc.
Notes to Condensed Consolidated Financial Statements (Unaudited) — (Continued)

In the fourth quarter of 2016, in addition to the grants made under the LTI program, the Company issued 1,107,505 stock options and expects to issue 499,704 PBRSUs to certain executive officers and other highly valued non-executive employees of the Company (although the actual number of PBRSUs has not been set and may be greater), provided that the issuance of such PBRSUs remain subject to the Board establishing the performance criteria and goals and maximum target number of shares. Such stock options were issued contingent upon stockholder approval of the Second A&R 2010 Plan at the 2016 Annual Meeting, and the future issuance of such PBRSUs will also be contingent upon such stockholder approval.

NOTE 8 — OTHER

Other costs are comprised of reorganization-related and certain other costs. For the three and nine months ended September 30, 2016, the Company incurred $0.5 million and $20.0 million in other costs, respectively. For the three and nine months ended September 30, 2015, the Company incurred $4.0 million and $5.9 million in other costs, respectively.

Reorganization-related

During the second quarter of 2016, the Company initiated a restructuring plan consisting of reductions in its workforce in order to align the size and composition of its workforce to its current client base, better position itself for already committed future growth, and enable the Company to more efficiently serve contracted demand. Restructuring charges for the three and nine months ended September 30, 2016 were $(0.2) million and $5.0 million. Restructuring charges for the nine months ended September 30, 2016 primarily consisted of $2.5 million in severance and employee benefits and related expenses, $0.7 million related to facility charges, and $1.8 million of non-cash expense related to share based compensation expense for the acceleration of existing RSAs for affected employees. The Company incurred restructuring charges of $2.4 million for the three and nine months ended September 30, 2015. The Company's reorganization liability activity is included in accrued compensation and benefits and other accrued expenses in the accompanying condensed consolidated balance sheets.

The Company's reorganization liability activity was as follows (in thousands):

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2016 | 2015 | 2016 | 2015 |
| | (unaudited) | | (unaudited) | |
| Reorganization liability, beginning balance | $5,493 | $844 | $2,493 | $3,454 |
| Restructuring charges | (182) | 2,428 | 5,013 | 2,428 |
| Cash payments | (4,055) | (852) | (4,422) | (3,462) |
| Non-cash payments | — | — | (1,828) | — |
| Reorganization liability, ending balance | $1,256 | $2,420 | $1,256 | $2,420 |

Other

During the three and nine months ended September 30, 2016, the Company incurred other costs of $0.0 million and $13.3 million, respectively, primarily related to incentive payments and legal fees paid in connection with the closing of the Transaction with Ascension Health Alliance and TowerBrook that was completed on February 16, 2016 (see Note 10). In addition, the Company incurred $0 and $0.9 million for additional contributions to the Company's defined contribution plan for the three and nine months ended September 30, 2016. For the three and nine months ended September 30, 2016, the Company incurred other costs of $0.7 million primarily related to the restatement of its previously issued consolidated financial statements (the "restatement'). For the three and nine months ended September 30, 2015, the Company incurred other costs of $0.7 million and $2.6 million, respectively, primarily related to the restatement. Restatement related costs are primarily legal, accounting and consulting costs.

NOTE 9 — INCOME TAXES

Income tax provisions for interim periods are based on estimated annual income tax rates, adjusted to reflect the effects of any significant infrequent or unusual items which are required to be discretely recognized within the current interim period. The Company's intention is to permanently reinvest its foreign earnings outside the United States. As a result, the effective tax rates in the periods presented are largely based upon the projected annual pre-tax earnings by jurisdiction and the allocation of certain expenses in various taxing jurisdictions where the Company conducts its business. These taxing jurisdictions apply a broad range of statutory income tax rates.

The income tax expense and benefit for the nine months ended September 30, 2016 and 2015 were higher than the amount derived by applying the federal statutory tax rate of 35% primarily due to the impact of state taxes. The tax rate is also impacted by discrete items that may occur in any given period.

The Company and its subsidiaries are subject to U.S. federal income taxes as well as income taxes in multiple state and foreign jurisdictions. The Company's 2013, 2012, and 2011 U.S. federal income tax returns are currently under examination. State jurisdictions have various open tax years. The statutes of limitations for most states range from three to six years.

During the nine months ended September 30, 2016 and 2015, respectively, the Company wrote-off approximately $10.0 million and $13.8 million of deferred tax assets due to the expiration and exercise of shared-based awards. The additional paid-in capital was reduced by the corresponding amount.

The decrease in the Company's deferred tax assets in the nine month period ended September 30, 2016 is due primarily to the contractual revenue recognition event related to Ascension. This event reduced the deferred customer billings deferred tax asset by approximately $137.4 million during the reporting period, offset by additions to deferred customer billings.

At December 31, 2015, the Company had deferred tax assets of $300.8 million, of which $48.2 million related to net operating loss carryforwards. The majority of these carryforwards were generated in 2013, 2014 and 2015 when the Company incurred substantial expenses related to the restatement. On February 16, 2016, the Company entered into the A&R MPSA with Ascension, effective February 16, 2016 with a term of 10 years. Pursuant to the A&R MPSA and with certain limited exceptions, the Company will become the exclusive provider of RCM services and PAS with respect to acute care services provided by the hospitals affiliated with Ascension that execute supplement agreements with the Company. At September 30, 2016, the Company believes its deferred tax assets will be realizable. Should the additional business with Ascension that the Company anticipates receiving in connection with the A&R MPSA not be as profitable as expected, such realizability assessment may change.

NOTE 10 — 8% SERIES A CONVERTIBLE PREFERRED STOCK

At the close of the Transaction on February 16, 2016 (as described in Note 1), the Company issued to TCP-ASC ACHI Series LLLP, a limited liability limited partnership jointly owned by Ascension Health Alliance and TowerBrook (the "Investor"): (i) 200,000 shares of Preferred Stock, for an aggregate price of $200 million, and (ii) a warrant with a term of ten years to acquire up to 60 million shares of common stock, par value $0.01 per share ("common stock"), at an exercise price of $3.50 per share, on the terms and subject to the conditions set forth in the Warrant Agreement ("Warrant"). The Preferred Stock is immediately convertible into shares of common stock.

The Company incurred direct and incremental expenses of $21.3 million (including $14.0 million in closing fees paid to the Investor) relating to financial advisory fees, closing costs, legal expenses and other offering-related expenses in connection with the Transaction. These direct and incremental expenses reduced the carrying amount of the Preferred Stock. In connection with the issuance of the Preferred Stock, a beneficial conversion feature of $48.3 million was recognized. Since the Preferred Stock is presently convertible into common stock, this amount was subsequently accreted to the carrying amount of the Preferred Stock, and treated as a deemed preferred stock dividend in the calculation of earnings per share.

Dividend Rights

The holders of the Preferred Stock are entitled to receive cumulative dividends January 1, April 1, July 1 and October 1 of each year (dividend payment dates), commencing on April 1, 2016, at a rate equal to 8% per annum (preferred dividend) multiplied by the liquidation preference per share, initially $1,000 per share adjusted for any unpaid cumulative preferred dividends. For the first seven years after issuance, the dividends on the Preferred Stock will be paid-in-kind. As of September 30, 2016, the Company had accrued dividends of $6.1 million associated with the Preferred Stock of which $6.0 million was paid in additional shares of Preferred Stock and $0.001 million was paid in cash in October. For the nine months ended September 30, 2016, the dividends that were paid, or accrued, in additional shares of Preferred Stock totaled $10.2 million.

Conversion Features

Each share of the Preferred Stock may be converted to common stock on any date at the option of the holder into the per share amount (as defined in the Certificate of Designations of the 8.00% Series A Convertible Preferred Stock (the "Series A COD")). Fractional shares will be rounded to the nearest whole share.

Redemption Rights

Since the redemption of the Preferred Stock is contingently or optionally redeemable and therefore not certain to occur, the Preferred Stock is not required to be classified as a liability under ASC 480, Distinguishing Liabilities from Equity. As the Preferred Stock is redeemable at the option of the holders upon a fundamental change (as defined in the Series A COD) and is redeemable in certain circumstances upon the occurrence of an event that is not solely within the Company's control, the Company has classified the Preferred Stock in mezzanine equity on the Condensed Consolidated Balance Sheets.

Voting Rights

Each holder of the Preferred Stock is entitled to vote with the common stock on an as-converted basis, and has full voting rights and powers equal to the voting rights and powers of the holders of common stock.

The following summarizes the Preferred Stock activity for the nine months ended September 30, 2016:

| | Preferred Stock | |
|---|---|---|
| | Shares Issued and Outstanding | Carrying Value |
| Balance at December 31, 2015 | — | $— |

| | | |
|---|---|---|
| Issuance of preferred stock | 200,000 | 108,909 |
| Beneficial conversion feature deemed dividend | — | 48,320 |
| Dividends paid/accrued dividends | 4,040 | 10,160 |
| Balance at September 30, 2016 | 204,040 | $167,389 |

NOTE 11 — EARNINGS PER SHARE

Basic net income per share is computed by dividing net income, less any dividends, accretion or decretion, redemption or induced conversion on the Preferred Stock, by the weighted average number of common shares

Accretive Health, Inc.
Notes to Condensed Consolidated Financial Statements (Unaudited) — (Continued)

outstanding during the period. As the Preferred Stock participates in dividends alongside the Company's common stock (per their participating dividends), the Preferred Stock would constitute participating securities under ASC 260-10 and are applied to earnings per share using the two-class method. Under this method, all earnings (distributed and undistributed) are allocated to common shares and participating securities based on their respective rights to receive dividends.

Diluted net income per share is calculated using the more dilutive of the if-converted or the two-class method. For the three and nine months ended September 30, 2016, the two-class method was more dilutive and was computed by adjusting the denominator used in the basic net income per share computation by the weighted average number of common shares outstanding and potentially dilutive securities outstanding during the period plus, when their effect is dilutive, incremental shares consisting of shares subject to stock options, shares issuable upon vesting of RSAs and Preferred Stock.

The following table sets forth the computation of basic and diluted earnings per share available to common shareholders for the three and nine months ended September 30, 2016 and 2015, respectively (in thousands, except share and per share data).

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2016 | 2015 | 2016 | 2015 |
| | (unaudited) | | (unaudited) | |
| Basic EPS: | | | | |
| Net income (loss) | $37,333 | $(32,970) | $163,945 | $(89,703) |
| Less dividends on preferred shares | (4,120) | — | (58,480) | — |
| Less income allocated to preferred shareholders | (15,092) | — | (43,423) | — |
| Net income (loss) available/(allocated) to common shareholders - basic | $18,121 | $(32,970) | $62,042 | $(89,703) |
| Diluted EPS: | | | | |
| Net income (loss) | 37,333 | (32,970) | 163,945 | (89,703) |
| Less dividends on preferred shares | (4,120) | — | (58,480) | — |
| Less income allocated to preferred shareholders | (14,991) | — | (43,132) | — |
| Net income (loss) available/(allocated) to common shareholders - diluted | $18,222 | $(32,970) | $62,333 | $(89,703) |
| Basic weighted-average common shares | 100,934,561 | 97,230,069 | 99,870,685 | 96,358,342 |
| Add: Effect of dilutive securities | 1,241,719 | — | 1,147,765 | — |
| Diluted weighted average common shares | 102,176,280 | 97,230,069 | 101,018,450 | 96,358,342 |
| Net income (loss) per common share (basic) | $0.18 | $(0.34) | $0.62 | $(0.93) |
| Net income (loss) per common share (diluted) | $0.18 | $(0.34) | $0.62 | $(0.93) |

Because of their anti-dilutive effect, 12,967,519 and 21,991,062 common share equivalents comprised of stock options and RSAs have been excluded from the diluted earnings per share calculation for the three months ended September 30, 2016 and 2015, respectively. Stock options and RSAs totaling 16,706,526 and 21,992,062 were not included in the computation of diluted income per share for the nine months ended September 30, 2016 and 2015, respectively, as these options and awards were anti-dilutive.

NOTE 12 — COMMITMENTS AND CONTINGENCIES

Legal Proceedings

Accretive Health, Inc.
Notes to Condensed Consolidated Financial Statements (Unaudited) — (Continued)

The Company is subject to various claims, other pending and possible legal actions for product liability and other damages, and other matters arising out of the conduct of the Company’s business. On a quarterly basis, the Company reviews material legal claims against the Company. The Company accrues for the costs of such claims as appropriate and in the exercise of its judgment and experience. However, due to a lack of factual information available to the Company about a claim, or the procedural stage of a claim, it may not be possible for the Company to reasonably assess either the probability of a favorable or unfavorable outcome of the claim or to reasonably estimate the amount of loss should there be an unfavorable outcome. Therefore, for many of the claims, the Company cannot estimate a range of loss. The Company believes, based on current knowledge and after consultation with counsel, that the outcome of such claims and actions will not have a material adverse effect on the Company’s results of operations or financial position. However, in the event of unexpected future developments, it is possible that the ultimate resolution of such matters, if unfavorable, could have a material adverse effect on the Company’s results of operations or financial position.

Other than as described below, the Company is not presently a party to any material litigation or regulatory proceeding and is not aware of any pending or threatened litigation or regulatory proceeding against the Company which, individually or in the aggregate, could have a material adverse effect on its business, operating results, financial condition or cash flows.

On February 11, 2014, the Company was named as a defendant in a putative class action lawsuit filed in the U.S. District Court for the Southern District of Alabama (Church v. Accretive Health, Inc.). The primary allegation is that the Company attempted to collect debts without providing the notice required by the Fair Debt Collection Practices Act ("FDCPA"). On November 24, 2015, the federal district court granted the Company's motion for summary judgment and dismissed the case with prejudice. Plaintiff filed a notice of appeal on December 21, 2015. The appeal was decided July 6, 2016, and the Eleventh Circuit Court of Appeals affirmed the dismissal of the case with prejudice, finding that the Company is not a debt collector as defined in the FDCPA.

On July 22, 2014, the Company was named as a defendant in a putative class action lawsuit filed in the U.S. District Court for the Eastern District of Michigan (Anger v. Accretive Health, Inc.). The primary allegations are that the Company attempted to collect debts without providing the notice required by the FDCPA and Michigan Fair Debt Collection Practices Act and failed to abide by the terms of an agreed payment plan in violation of those same statutes. On August 27, 2015, the Court granted in part and denied in part the Company’s motion to dismiss. An amended complaint was filed on November 30, 2015. Discovery is underway, but on July 15, 2016, the court postponed all deadlines in the case as the parties attempt to finalize a confidential agreement in principle to settle the case. The Company believes that it has meritorious defenses and intends to vigorously defend itself against these claims, if the settlement in principle is not finalized.

In April 2015, the Company was named among other defendants in an employment action brought by a former employee before the Maine Human Rights Commission ("MHRC"), alleging that she was improperly terminated in retaliation for uncovering alleged Medicare fraud. The Company filed its response with the MHRC on May 19, 2015 seeking that the Company be dismissed entirely from the action. On June 23, 2015, the MHRC issued its Notice of Right to Sue and decision to terminate its process with respect to all charges asserted by the former employee. The Plaintiff has filed a parallel qui tam action in the District of Maine (Worthy v. Eastern Maine Healthcare Systems) in which she makes the same allegations. The U.S. Department of Justice declined to intervene in the federal court action, and the case was unsealed in April 2015. The Company and other defendants filed motions to dismiss the Third Amended Complaint on March 21, 2016. Those motions are now fully briefed and awaiting decision by the federal district court. The Company believes that it has meritorious defenses to both the employment law-related retaliation claim for which the MHRC has granted the Notice of Right to Sue letter and the federal qui tam case, and intends to vigorously defend itself against these claims. The outcomes are not presently determinable.

On June 17, 2015, the Company filed a confidential arbitration demand with the American Arbitration Association against Salem Hospital for unpaid fees due under the parties' Accretive Health Services Agreement. The case settled in August 2016 for an immaterial amount.

In May 2016, the Company was served with a False Claims Act case brought by a former emergency department service associate who worked at a hospital of one of the Company's customers, MedStar Inc.'s Washington Hospital Center ("WHC"), along with WHC and three other hospitals that were PAS clients and a place holder, John Doe hospital, representing all PAS clients (USA ex rel. Graziosi vs. Accretive Health, Inc. et. al.). The Second Amended Complaint alleges that the Company's PAS business violates the federal False Claims Act. The case was originally filed under seal in 2013 in the federal district court in Chicago, was presented to the U.S. Attorney in Chicago twice, and the U.S. Attorneys declined to intervene. The Company filed a motion to dismiss the Second Amended Complaint on July 29, 2016. Those motions are now fully briefed and awaiting decision by the federal district court. The Company believes that it has meritorious defenses to all claims in the case, and intends to vigorously defend itself against these claims. The outcome is not presently determinable.

## NOTE 13 — RELATED PARTY TRANSACTIONS

As a result of the closing of the Transaction on February 16, 2016 and Ascension's ownership interest in the Investor, Ascension became a related party to the Company. See Note 10, 8% Series A Convertible Preferred Stock, for additional information.

The Company provides RCM services to Ascension. The execution of the A&R MPSA, as discussed in Note 1, was a contractual settlement agreement of the prior Master Professional Services Agreement between the Company and Ascension. Therefore, the Company recorded revenue of $343.4 million in connection with these services for the nine months ended September 30, 2016. In addition to the revenue recorded related to the execution of the A&R MPSA, the Company recorded revenue from services provided to Ascension of $22.7 and $22.8 for the three and nine months ended September 30, 2016, respectively. At September 30, 2016, the Company had $124.1 in current portion of customer liabilities for a related party, consisting of $31.8 million in current accrued service costs, $7.5 million in current customer deposits and $84.8 million in current deferred customer billings. The Company had $62.8 million in non-current portion of customer liabilities for a related party related to deferred customer billings as of September 30, 2016.

As part of the transition of Ascension personnel to the Company in conjunction with the A&R MPSA, the Company has agreed to reimburse Ascension for certain severance and retention costs related to certain Ascension employees who will not be transitioned to the Company. The Company has accrued $1.5 million in accrued compensation and benefits at September 30, 2016 related to these costs.

As Ascension is the Company's largest customer, a significant percentage of the Company's cost of services is associated with providing services to Ascension. However, due to the nature of the Company's shared services and information technology operations, it is impractical to assign the dollar amount associated with services provided to Ascension.

## NOTE 14 — DEFERRED CONTRACT COSTS

Eligible, one-time, nonrecurring costs associated with the initial phases of the Ascension A&R MPSA and with the transition of additional Ascension hospitals are deferred and subsequently amortized. The costs related to transition or setup activities for personnel, process, and systems are amortized on a straight-line basis over the expected period of benefit. At September 30, 2016, the Company had $2.8 million in deferred eligible costs and did not have any eligible costs deferred at December 31, 2015. These deferred costs are included in other assets in the accompanying condensed consolidated balance sheets. Any contracts entered into by the Company having similar characteristics will be accounted for in a similar manner.

## NOTE 15 — SEGMENTS AND CUSTOMER CONCENTRATIONS

The Company has determined that it has a single operating segment in accordance with how its business activities are managed and evaluated. All of the Company's significant operations are organized around the single business of providing end-to-end management services of revenue cycle operations for U.S.-based hospitals and other medical providers. Accordingly, for purposes of segment disclosures, the Company has only one reporting segment. All of the Company’s net services revenue and trade accounts receivable are derived from healthcare providers domiciled in the United States.

Hospital systems affiliated with Ascension have accounted for a significant portion of the Company’s net services revenue each year since the Company’s formation. For the three months ended September 30, 2016, net services revenue from hospitals affiliated with Ascension accounted for 18% of the Company's total net services revenue. For the three months ended September 30, 2016, one customer, unaffiliated with Ascension, accounted for 70% of the Company's total net services revenue. For the nine months ended September 30, 2016, net services revenue from hospitals affiliated with Ascension accounted for 75% of the Company's total net services revenue. For the nine months ended September 30, 2016, one customer, unaffiliated with Ascension, accounted for 18% of the Company's total net services revenue. The Company did not have any revenue associated with Ascension for the three and nine months ended September 30, 2015. For the three months and nine months ended September, 30, 2015, three different customers, unaffiliated with Ascension, accounted for 59% and 54% of the Company's total net services revenue, respectively. The Ascension system, through its individual customer contracts with the Company, accounted for 69% and 75% of the Company’s total deferred customer billings at September 30, 2016 and December 31, 2015, respectively. The loss of customers within the Ascension health system would have a material adverse impact on the Company’s operations.

As of September 30, 2016, the Company had a concentration of credit risk with one customer, unaffiliated with Ascension, accounting for 33% of accounts receivable.The Company did not have a concentration of credit risk within accounts receivable as reported in the consolidated balance sheets with any one large customer at December 31, 2015.

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

Unless the context indicates otherwise, references in this Quarterly Report on Form 10-Q to "Accretive Health," "the Company," "we," "our," and "us" mean Accretive Health, Inc., and its subsidiaries.

The following discussion and analysis is an integral part of understanding our financial results and is provided as an addition to, and should be read in connection with, our condensed consolidated financial statements and the accompanying notes. Also refer to Note 1 of our condensed consolidated financial statements.

This Quarterly Report on Form 10-Q contains "forward-looking statements" within the meaning of the federal securities laws, that involve substantial risks and uncertainties. These statements are often identified by the use of words such as "anticipate," "believe," "estimate," "expect," "intend," "may," "plan," "predict," "project," "would" and similar expressions or Such forward-looking statements are subject to risks, uncertainties and other factors that could cause actual results and the timing of certain events to differ materially from future results expressed or implied by such forward-looking statements. Factors that could cause or contribute to such differences include, but are not limited to, those discussed in the section titled "Risk Factors," in Part II, Item 1A of this Quarterly Report on Form 10-Q, and elsewhere in this Report, as well as those set forth in Part I, Item 1A of the 2015 10-K as well as our other filings with the SEC. The forward-looking statements in this Quarterly Report on Form 10-Q represent our views as of the date of this Quarterly Report on Form 10-Q. Subsequent events and developments may cause our views to change. While we may elect to update these forward-looking statements at some point in the future, we have no current intention of doing so except to the extent required by applicable law. You should, therefore, not rely on these forward-looking statements as representing our views as of any date subsequent to the date of this Quarterly Report on Form 10-Q.

## OVERVIEW

### Our Business

We are a leading provider of services that help healthcare providers generate sustainable improvements in their operating margins and cash flows while also improving patient, physician and staff satisfaction for our customers. Our goal is to help our healthcare provider customers deliver high-quality care and serve their communities, and do so in a financially sustainable way. We help our customers more efficiently manage their revenue cycle process and strive to help prepare them for the evolving dynamics of the healthcare industry, particularly the challenges and opportunities presented by the shift to value-based reimbursement which is designed to reward the value, rather than the volume, of healthcare services provided.

While we cannot control the changes in the regulatory environment imposed on our customers, we believe that our role becomes increasingly more important to our customers as macroeconomic, regulatory and healthcare industry conditions continue to impose financial pressure on healthcare providers to manage their operations effectively and efficiently.

RCM continues to be our primary service offering. Our RCM offering helps our customers more efficiently manage their revenue cycle process. This encompasses patient registration, insurance and benefit verification, medical treatment documentation and coding, bill preparation and collections. We focus on optimizing our customers' entire, end-to-end revenue cycle process, which we believe is more advantageous than alternative approaches that merely focus on certain aspects or sub-processes within the revenue cycle. Our PAS offering complements our RCM offering by strengthening our customers' compliance with certain third-party payer requirements and limiting denials of claims. For example, our PAS offering helps customers determine whether to classify a hospital visit as an in-patient or an out-patient observation case for billing purposes. Additionally, we believe that we can leverage our RCM capabilities to help providers navigate and optimize their performance within value-based payment models, and that we are well positioned to help our clients adapt to evolving value-based reimbursement structures.

We operate our business as a single segment configured with our significant operations and offerings organized around the business of providing end-to-end RCM services to U.S.-based hospitals and other healthcare providers.

Business Update

In December 2015, we announced the Transaction with Ascension Health Alliance and TowerBrook, which closed on February 16, 2016. As part of the Transaction, we entered into the A&R MPSA with Ascension, effective February 16, 2016 with a term of ten years. Pursuant to the A&R MPSA and with certain limited exceptions, we will become the exclusive provider of RCM services and PAS with respect to acute care services provided by the hospitals affiliated with Ascension that execute supplement agreements with us.

We expect the Transaction to expand our relationship with Ascension, grow our overall business, and improve our ability to win customers outside of the Ascension hospital base. Under the A&R MPSA, our RCM services for both Ascension hospitals that we currently service and Ascension hospitals that we intend to service will be transitioning to an outsourced business model, whereby a significant number of Ascension's revenue cycle employees will become our employees as we begin implementing the A&R MPSA and providing our services to Ascension hospitals over a three year period. As a result of the implementation of an outsourced business model in connection with the A&R MPSA, we expect to expand our operations in the United States and off shore and intend to invest in technology, facilities and talent to support our anticipated growth. Such outsourced business model will also require the transition of the non-payroll related expenses supporting Ascension's revenue cycle operations to direct expenses of Accretive Health. These transitioned expenses have historically been managed by our infused management staff but remained on the hospitals' financial records. This new in-house capability of managing these expenses will allow us to pursue new business opportunities which require an outsourced business model. We believe the ten year term of the A&R MPSA, together with the significant investment in Accretive Health by Ascension, our largest customer, will provide our business with stability and growth. In addition, our management team will benefit from the oversight provided by having TowerBrook involved as a strategic investor.

CONSOLIDATED RESULTS OF OPERATIONS

The following table provides consolidated operating results and other operating data for the periods indicated (unaudited):

| | Three Months Ended September 30, | | 2016 vs. 2015 Change | | Nine Months Ended September 30, | | 2016 vs. 2015 Change | |
|---|---|---|---|---|---|---|---|---|
| | 2016 | 2015 | Amount | % | 2016 | 2015 | Amount | % |
| | (In thousands except percentages) | | | | | | | |
| Consolidated Statement of Operations Data: | | | | | | | | |
| RCM services: net operating fees | $48,950 | $6,232 | $42,718 | fav. | $300,259 | $19,402 | $280,857 | fav. |
| RCM services: incentive fees | 68,538 | 1,017 | 67,521 | fav. | 166,537 | 9,022 | 157,515 | fav. |
| RCM services: other | 3,830 | 5,359 | (1,529) | (28.5)% | 8,292 | 9,591 | (1,299) | (13.5)% |
| Other service fees | 4,217 | 3,234 | 983 | 30.4 % | 11,312 | 10,883 | 429 | 3.9 % |
| Total net services revenue | 125,535 | 15,842 | 109,693 | fav. | 486,400 | 48,898 | 437,502 | fav. |
| Operating expenses: | | | | | | | | |
| Cost of services | 47,376 | 45,326 | 2,050 | 4.5 % | 137,618 | 130,284 | 7,334 | 5.6 % |
| Selling, general and administrative | 16,201 | 21,395 | (5,194) | (24.3)% | 58,397 | 59,726 | (1,329) | (2.2)% |
| Other | 536 | 3,964 | (3,428) | (86.5)% | 19,993 | 5,850 | 14,143 | unfav. |
| Total operating expenses | 64,113 | 70,685 | (6,572) | (9.3)% | 216,008 | 195,860 | 20,148 | 10.3 % |
| Income (loss) from operations | 61,422 | (54,843) | 116,265 | fav. | 270,392 | (146,962) | 417,354 | fav. |
| Net interest income | 57 | 73 | (16) | (21.9)% | 187 | 147 | 40 | 27.2 % |
| Net income (loss) before income tax provision | 61,479 | (54,770) | 116,249 | fav. | 270,579 | (146,815) | 417,394 | fav. |
| Income tax provision (benefit) | 24,146 | (21,800) | 45,946 | fav. | 106,634 | (57,112) | 163,746 | unfav. |
| Net income (loss) | $37,333 | $(32,970) | $70,303 | fav. | 163,945 | (89,703) | 253,648 | fav. |

fav. - Favorable

unfav. - Unfavorable

Use of Non-GAAP Financial Information
We typically invoice customers for base fees and incentive fees on a quarterly or monthly basis, and typically receive cash from customers on a similar basis. For GAAP reporting purposes, we only recognize these net operating fees and incentive fees as net services revenue to the extent that all the criteria for revenue recognition are met, which is generally upon contract renewal, termination or other contractual agreement. As such, net operating and incentive fees are typically recognized for GAAP purposes in periods subsequent to the periods in which the services are provided. Therefore, our net services revenue and other items in our GAAP consolidated financial statements and adjusted EBITDA will typically include the effects of billings and collections from periods prior to the period in which revenue is recognized.
In order to provide a more comprehensive understanding of the information used by our management team in financial and operational decision-making, we supplement our GAAP consolidated financial statements with the following non-GAAP financial measures: gross and net cash generated from customer contracting activities, and adjusted EBITDA.
Our Board and management team use these non-GAAP measures as (i) one of the primary methods for planning and forecasting overall expectations and for evaluating actual results against such expectations; and (ii) as a performance evaluation metric in determining achievement of certain executive incentive compensation programs, as well as for incentive compensation plans for employees.
Selected Non-GAAP Measures
The following table presents selected non-GAAP measures for each of the periods indicated. See below for an explanation of how we calculate and use these non-GAAP measures, and for a reconciliation of these non-GAAP measures to the most comparable GAAP measure.

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2016 | 2015 | 2016 | 2015 |
| Non-GAAP Measures: | (in thousands) | | (in thousands) | |
| Adjusted EBITDA | $69,391 | $(35,826) | $321,133 | $(109,238) |
| Net cash generated from customer contracting activities | $3,586 | $3,715 | $(26,409) | $(637) |
| Gross cash generated from customer contracting activities | $59,730 | $55,383 | $138,858 | $157,499 |

Gross and Net Cash Generated from Customer Contracting Activities
Gross and net cash generated from customer contracting activities reflect the change in the deferred customer billings, relative to GAAP net services revenue, and adjusted EBITDA (defined below), respectively. Deferred customer billings include the portion of both (i) invoiced or accrued net operating fees and (ii) cash collections of incentive fees, in each case, that have not met our revenue recognition criteria. Deferred customer billings are included in the detail of our customer liabilities balance in the condensed consolidated balance sheet. Deferred customer billings are reduced by the amounts of revenue recognized when a revenue recognition event occurs. Gross cash generated from customer contracting activities is defined as GAAP net services revenue, plus the change in deferred customer billings. Accordingly, gross cash generated from customer contracting activities is the sum of (i) invoiced or accrued net operating fees, (ii) cash collections on incentive fees and (iii) other services fees.
Net cash generated from customer contracting activities is defined as adjusted EBITDA, plus the change in deferred customer billings.
These non-GAAP measures are used throughout this Quarterly Report on Form 10-Q including in this Management’s Discussion and Analysis of Financial Condition and Results of Operations.

Gross and net cash generated from customer contracting activities include invoices issued to customers that may remain uncollected or may be subject to credits, and cash collected may be returned to our customers in the form of concessions or other adjustments. Customer concessions and other adjustments have occurred in the past and we cannot determine the likelihood that they will again occur in the future.

Adjusted EBITDA

We define adjusted EBITDA as net income before net interest income, income tax provision, depreciation and amortization expense, share-based compensation expense, reorganization-related expense and certain other items. The use of adjusted EBITDA to measure operating and financial performance is limited by our revenue recognition criteria, pursuant to which GAAP net services revenue is recognized at the end of a contract or "other contractual agreement event". Adjusted EBITDA does not adequately match corresponding cash flows resulting from customer contracting activities. Accordingly, as described above, in order to better compare our cash flows from customer contracting activities to our operating performance, we use additional non-GAAP measures: gross and net cash generated from customer contracting activities. We use adjusted EBITDA in our reconciliation of net cash generated from customer contracting activities to our GAAP consolidated financial statements.

We understand that, although non-GAAP measures are frequently used by investors, securities analysts, and others in their evaluation of companies, these measures have limitations as analytical tools, and you should not consider them in isolation or as a substitute for analysis of our results of operations as reported under GAAP. Some of these limitations are:

- Gross and net cash generated from customer contracting activities include invoiced or accrued net operating fees, and invoiced as well as collected incentive fees which may be subject to adjustment or concession prior to the end of a contract or "other contractual agreement event";
- Gross and net cash generated from customer contracting activities include progress billings on incentive fees that have been collected for a number of our RCM contracts. These progress billings have, from time-to-time, been subject to adjustments, and the fees included in these non-GAAP measures may be subject to adjustments in the future;
- Net cash generated from customer contracting activities and adjusted EBITDA do not reflect changes in, or cash requirements for, our working capital needs;
- Net cash generated from customer contracting activities and adjusted EBITDA do not reflect share-based compensation expense;
- Net cash generated from customer contracting activities and adjusted EBITDA do not reflect income tax expenses or cash requirements to pay taxes;
- Although depreciation and amortization charges are non-cash charges, the assets being depreciated and amortized will often have to be replaced in the future, and net cash generated from customer contracting activities and adjusted EBITDA do not reflect cash requirements for such replacements or other purchase commitments, including lease commitments; and
- Other companies in our industry may calculate gross or net cash generated from customer contracting activities or adjusted EBITDA differently than we do, limiting its usefulness as a comparative measure.

Reconciliation of GAAP and Non-GAAP Measures

The following table represents a reconciliation of adjusted EBITDA and gross and net cash generated from customer contracting activities to net income (loss), the most comparable GAAP measure, for each of the periods indicated (in thousands, except percentages).

| | Three Months Ended September 30, | | 2016 vs. 2015 Change | | Nine Months Ended September 30, | | 2016 vs. 2015 Change | |
|---|---|---|---|---|---|---|---|---|
| | 2016 | 2015 | Amount | % | 2016 | 2015 | Amount | % |
| Net income (loss) | $37,333 | $(32,970) | $70,303 | fav. | $163,945 | $(89,703) | $253,648 | fav. |
| Net interest income | (57) | (73) | 16 | (21.9)% | (187) | (147) | (40) | 27.2 % |
| Income tax provision (benefit) | 24,146 | (21,800) | 45,946 | unfav. | 106,634 | (57,112) | 163,746 | unfav. |
| Depreciation and amortization expense | 2,673 | 2,738 | (65) | (2.4)% | 7,305 | 6,556 | 749 | 11.4 % |
| Share-based compensation expense (1) | 4,760 | 12,315 | (7,555) | (61.3)% | 23,443 | 25,318 | (1,875) | (7.4)% |
| Other (2) | 536 | 3,964 | (3,428) | fav. | 19,993 | 5,850 | 14,143 | unfav. |
| Adjusted EBITDA | 69,391 | (35,826) | 105,217 | fav. | 321,133 | (109,238) | 430,371 | fav. |
| Change in deferred customer billings (3) | (65,805) | 39,541 | (105,346) | n.m | (347,542) | 108,601 | (456,143) | n.m. |
| Net cash generated from customer contracting activities | $3,586 | $3,715 | $(129) | unfav. | $(26,409) | $(637) | $(25,772) | unfav. |
| Net services revenue (GAAP basis) | $125,535 | 15,842 | $109,693 | fav. | $486,400 | 48,898 | 437,502 | fav. |
| Change in deferred customer billings (3) | (65,805) | 39,541 | (105,346) | n.m | (347,542) | 108,601 | (456,143) | n.m |
| Gross cash generated from customer contracting activities | $59,730 | $55,383 | $4,347 | 7.8 % | $138,858 | $157,499 | $(18,641) | (11.8)% |
| Components of Gross Cash Generated from Customer Contracting Activities: | | | | | | | | |
| RCM services: net operating fees | $46,124 | $31,522 | $14,602 | 46.3 % | $94,814 | $88,761 | $6,053 | 6.8 % |
| RCM services: incentive fees | 7,568 | 14,859 | (7,291) | (49.1)% | 23,803 | 47,501 | (23,698) | (49.9)% |
| RCM services: other | 1,821 | 5,749 | (3,928) | (68.3)% | 8,929 | 10,196 | (1,267) | (12.4)% |
| Total RCM service fees | 55,513 | 52,130 | $3,383 | 6.5 % | 127,546 | 146,458 | (18,912) | (12.9)% |
| Other service fees | 4,217 | 3,253 | 964 | 29.6 % | 11,312 | 11,041 | 271 | 2.5 % |
| Gross cash generated from customer contracting activities | $59,730 | $55,383 | $4,347 | 7.8 % | $138,858 | $157,499 | $(18,641) | (11.8)% |

fav. - Favorable
unfav. - Unfavorable
n.m. - Not meaningful

(1) Share-based compensation expense represents the expense associated with stock options and restricted shares granted, as reflected in our Condensed Consolidated Statements of Operations and Comprehensive Income (Loss). $1.8 million of non-cash expense related to share-based compensation expense for the acceleration of existing

RSAs for employees affected by the Company's June restructuring and is included in Other. See Note 7, Share-Based Compensation, to the Condensed Consolidated Financial Statements included in this Quarterly Report on Form 10-Q for the detail of the amounts of share-based compensation expense.

(2) Other costs are comprised of reorganization-related and certain other costs. For the three and nine months ended September 30, 2016, we incurred other costs of $0.5 million and $20.0 million, respectively. The costs incurred during the nine months ended September 30, 2016 primarily related to the incentive payments and legal fees paid in

connection with the closing of the Transaction with Ascension Health Alliance and TowerBrook on February 16, 2016 of $13.3 million. For the three and nine months ended September 30, 2016, the Company incurred other costs of $0.7 million primarily related to the restatement. For the three and nine months ended September 30, 2015, we incurred other costs of $4.0 million and $5.9 million, respectively, primarily in restatement-related costs related to professional service fees. Restructuring charges for the three and nine months ended September 30, 2016 were $(0.2) million and $5.0 million. We did not incur any reorganization-related costs during the three and nine months ended September 30, 2015. For the three and nine months ended September 30, 2015, the Company incurred other costs of $0.7 million and $2.6 million, respectively, primarily related to the restatement. Restatement related costs are primarily legal, accounting and consulting costs.

(3) Deferred customer billings include the portion of both (i) invoiced or accrued net operating fees and (ii) cash collections on incentive fees, in each case, that have not met our revenue recognition criteria. Deferred customer billings are included in the detail of our customer liabilities account in the condensed consolidated balance sheet. Deferred customer billings are reduced by revenue recognized when revenue recognition occurs. Change in deferred customer billings represents the net change in the cumulative net operating fees and incentive fees that have not met revenue recognition criteria.

Three Months Ended September 30, 2016 Compared to Three Months Ended September 30, 2015

Net Services Revenue

Net services revenue increased by $109.7 million, to $125.5 million for the three months ended September 30, 2016, from $15.8 million for the three months ended September 30, 2015. The increase was predominantly driven by an increase in RCM net services revenue of $106.8 million due to RCM contractual agreement events and a $1.9 million increase due to an increase in fixed fee revenue. Additionally, there was a $1.0 million increase in other service fees primarily due to an increase in PAS revenue.

Gross Cash Generated from Customer Contracting Activities (Non-GAAP)

Gross cash generated from customer contracting activities for the three months ended September 30, 2016 increased by $4.3 million, or 7.8%, to $59.7 million, from $55.4 million for the three months ended September 30, 2015. The increase was primarily related to an increase of $3.4 million in gross cash generated from RCM services resulting from the movement toward fixed fee contracts and the transition to the A&R MPSA. The transition to the A&R MPSA results in change in classification of costs from an offset to Net Operating Fees to Cost of Services, resulting in an increase in gross cash generated. Additionally, other service fees increased by $1.0 million primarily due to an increase in PAS revenue. For an explanation of how we calculate gross cash generated from customer contracting activities, refer to the “Reconciliation of GAAP and Non-GAAP Measures” above.

Costs of Services

Costs of services increased by $2.1 million, or 4.5%, to $47.4 million for the three months ended September 30, 2016, from $45.3 million for the three months ended September 30, 2015. The increase in costs was primarily due to transition to the A&R MPSA and implementation of International Classification of Diseases, Tenth Edition ("ICD-10"), a clinical cataloging system that went into effect for the U.S. healthcare industry on October 1, 2015. The transition to the A&R MPSA results in change in classification of costs from an offset to Net Operating Fees to Cost of Services.

Selling, General and Administrative Expenses

Selling, general and administrative expenses decreased by $5.2 million, or 24.3%, to $16.2 million for the three months ended September 30, 2016, from $21.4 million for the three months ended September 30, 2015. The decrease was primarily due to a decrease in share-based compensation expense of $5.7 million. During the third quarter of 2015, RSAs were granted and cash bonuses of $1.8 million were paid to those participants in the Company's 2014 annual cash incentive bonus plan who received all or a portion of their 2014 annual cash incentive award in the form of restricted shares of the Company's common stock. No such expense was incurred for the three months ended September 30, 2016.

Net Cash Generated from Customer Contracting Activities (Non-GAAP)
Net cash generated from customer contracting activities was $3.6 million for the three months ended September 30, 2016, compared to $3.7 million for the three months ended September 30, 2015. This increase of $0.1 million was primarily due to an increase in gross cash generated from customer contracting activities offset by an increase in cost of services as explained above. For an explanation of how we calculate net cash generated from customer contracting activities, refer to "Reconciliation of GAAP and Non-GAAP Measures" above.
Other
Other costs decreased by $3.4 million, to $0.5 million for the three months ended September 30, 2016, from $4.0 million for the three months ended September 30, 2015. This decrease was primarily attributable to costs related to exploration of potential strategic alternatives and reorganization-related costs incurred in the three months ended September 30, 2015. No such expense was incurred for the three months ended September 30, 2016.

Income Taxes
Tax expense increased by $45.9 million to a tax expense of $24.1 million for the three months ended September 30, 2016, from a benefit of $21.8 million for the three months ended September 30, 2015, primarily due to an increase in pretax income. Our effective tax rate for the three months ended September 30, 2016 and 2015 was 39.3% and 39.8%, respectively. Our tax rate is affected by changes in state tax rates and discrete items that may occur in any given period but not consistent from year to year.
Nine Months Ended September 30, 2016 Compared to Nine Months Ended September 30, 2015
Net Services Revenue
Net services revenue increased by $437.5 million to $486.4 million for the nine months ended September 30, 2016, from $48.9 million for the nine months ended September 30, 2015. The increase was primarily due to contractual agreement events related to Ascension and other RCM clients during the nine months ended September 30, 2016, resulting in revenue recognition of $450.2 million in net services revenue, partially offset by the recognition of revenue from contractual agreement events during the nine months ended September 30, 2015.
Gross Cash Generated from Customer Contracting Activities (Non-GAAP)
Gross cash generated from customer contracting activities totaled $138.9 million for the nine months ended September 30, 2016, compared to $157.5 million for the nine months ended September 30, 2015, a decrease of $18.6 million. The decrease in gross cash generated was primarily driven by RCM services, due to movement toward fixed fee contracts, reduction in the scope of services for certain customers and customer attrition. For an explanation of how we calculate gross cash generated from customer contracting activities, refer to the “Reconciliation of GAAP and Non-GAAP Measures” above.
Costs of Services
Costs of services increased by $7.3 million, or 5.6%, to $137.6 million for the nine months ended September 30, 2016, from $130.3 million for the nine months ended September 30, 2015. The increase in costs was primarily due to implementation of ICD-10, a clinical cataloging system that went into effect for the U.S. healthcare industry on October 1, 2015 and transition to the A&R MPSA. Additionally, the transition to the A&R MPSA has resulted in a change in classification of costs from an offset to Net Operating Fees to Cost of Services.

Selling, General and Administrative Expenses

Selling, general and administrative expenses decreased by $1.3 million, or 2.2%, to $58.4 million for the nine months ended September 30, 2016, from $59.7 million for the nine months ended September 30, 2015. The decrease was primarily due to a decrease in stock compensation expense.