

Grand Canyon Education, Inc.
Form 10-Q
November 08, 2018
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2018

or

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

For the transition period from to

Commission File Number: 001-34211

GRAND CANYON EDUCATION, INC.

(Exact name of registrant as specified in its charter)

DELAWARE
(State or other jurisdiction of
Incorporation or organization)

20-3356009
(I.R.S. Employer
Identification No.)

2600 W. Camelback Road
Phoenix, Arizona 85017

(Address, including zip code, of principal executive offices)

(602) 247-4400

(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 No

Indicate by check mark whether the registrant has submitted electronically every Interactive Data File required to be submitted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit such files). Yes No

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller reporting company

Emerging growth company

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

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

The total number of shares of common stock outstanding as of November 5, 2018, was 48,133,425.

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	Three Months Ended September 30,		Nine Months Ended September 30,	
	2018	2017	2018	2017
<u>(In thousands, except per share data)</u>				
Service revenue	\$ 155,454	\$	\$ 155,454	\$
University related revenue		236,209	512,499	702,716
Net revenue	155,454	236,209	667,953	702,716
Costs and expenses:				
Technology and academic services	11,101	10,494	32,476	31,095
Counseling services and support	51,116	46,100	152,701	138,382
Marketing and communication	31,546	28,130	90,168	82,865
General and administrative	10,092	8,343	23,273	21,182
University related expenses	6,569	83,450	173,735	237,784
Loss on Transaction	15,610		17,600	
Total costs and expenses	126,034	176,517	489,953	511,308
Operating income	29,420	59,692	178,000	191,408
Interest income on Secured Note	13,248		13,248	
Interest expense	(558)	(567)	(961)	(1,642)
Investment interest and other	371	1,445	2,919	2,186
Income before income taxes	42,481	60,570	193,206	191,952
Income tax expense	8,720	21,266	39,726	56,889
Net income	\$ 33,761	\$ 39,304	\$ 153,480	\$ 135,063
Earnings per share:				
Basic income per share	\$ 0.71	\$ 0.83	\$ 3.22	\$ 2.87
Diluted income per share	\$ 0.70	\$ 0.81	\$ 3.17	\$ 2.80

Basic weighted average shares outstanding	47,682	47,316	47,592	47,083
Diluted weighted average shares outstanding	48,422	48,292	48,429	48,197

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

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GRAND CANYON EDUCATION, INC.

Consolidated Statements of Comprehensive Income

(Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2018	2017	2018	2017
(In thousands)				
Net income	\$ 33,761	\$ 39,304	\$ 153,480	\$ 135,063
Other comprehensive income, net of tax:				
Unrealized gains (losses) on available-for-sale securities, net of taxes of \$44 and \$25 for the three months ended September 30, 2018 and 2017, respectively, and \$6 and \$257 for the nine months ended September 30, 2018 and 2017, respectively	(133)	40	(20)	416
Unrealized gains (losses) on hedging derivatives, net of taxes of \$2 and \$20 for the three months ended September 30, 2018 and 2017, respectively, and \$81 and \$65 for the nine months ended September 30, 2018 and 2017, respectively	(4)	(30)	248	(104)
Comprehensive income	\$ 33,624	\$ 39,314	\$ 153,708	\$ 135,375

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

Table of Contents**GRAND CANYON EDUCATION, INC.****Consolidated Balance Sheets**

	September 30, 2018 (Unaudited)	December 31, 2017
ASSETS:		
(In thousands, except par value)		
Current assets		
Cash and cash equivalents	\$ 44,879	\$ 153,474
Restricted cash and cash equivalents	61,667	94,534
Investments	68,754	89,271
Accounts receivable, net	65,120	10,908
Interest receivable on secured note	4,381	
Income tax receivable	1,791	2,086
Other current assets	8,607	24,589
Total current assets	255,199	374,862
Property and equipment, net	110,908	922,284
Note receivable	882,900	
Prepaid royalties		2,763
Goodwill	2,941	2,941
Other assets	743	723
Total assets	\$ 1,252,691	\$ 1,303,573
LIABILITIES AND STOCKHOLDERS EQUITY:		
Current liabilities		
Accounts payable	\$ 16,996	\$ 29,139
Accrued compensation and benefits	17,857	23,173
Accrued liabilities	13,511	20,757
Income taxes payable		16,182
Student deposits		95,298
Deferred revenue		46,895
Current portion of notes payable	6,572	6,691
Total current liabilities	54,936	238,135
Other noncurrent liabilities		1,200
Deferred income taxes, noncurrent	4,421	18,362
Notes payable, less current portion	54,976	59,925
Total liabilities	114,333	317,622
Commitments and contingencies		
Stockholders equity		

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Preferred stock, \$0.01 par value, 10,000 shares authorized; 0 shares issued and outstanding at September 30, 2018 and December 31, 2017		
Common stock, \$0.01 par value, 100,000 shares authorized; 52,570 and 52,277 shares issued and 48,134 and 48,125 shares outstanding at September 30, 2018 and December 31, 2017, respectively	526	523
Treasury stock, at cost, 4,436 and 4,152 shares of common stock at September 30, 2018 and December 31, 2017, respectively	(119,982)	(100,694)
Additional paid-in capital	251,828	232,670
Accumulated other comprehensive loss	(652)	(724)
Retained earnings	1,006,638	854,176
Total stockholders equity	1,138,358	985,951
Total liabilities and stockholders equity	\$ 1,252,691	\$ 1,303,573

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

Table of Contents**GRAND CANYON EDUCATION, INC.****Consolidated Statement of Stockholders Equity****(In thousands)****(Unaudited)**

	Common Stock		Treasury Stock		Additional	Other	Retained	Total
	Shares	Par Value	Shares	Cost	Paid-in	Comprehensive	Earnings	
					Capital	Loss		
B a l a n c e a t								
December 31, 2017	52,277	\$ 523	4,152	\$(100,694)	\$ 232,670	\$ (724)	\$ 854,176	\$ 985,951
Cumulative effect from the adoption of accounting pronouncements, net of taxes							(1,174)	(1,174)
Comprehensive income						228	153,480	153,708
Adoption impact ASU 2018-02						(156)	156	
C o m m o n s t o c k purchased for treasury			39	(4,135)				(4,135)
Restricted shares forfeited			94					
S h a r e - b a s e d compensation	163	2	151	(15,153)	17,064			1,913
Exercise of stock options	130	1			2,094			2,095
Balance at September 30, 2018	52,570	\$ 526	4,436	\$(119,982)	\$ 251,828	\$ (652)	\$ 1,006,638	\$ 1,138,358

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

Table of Contents**GRAND CANYON EDUCATION, INC.****Consolidated Statements of Cash Flows****(Unaudited)**

(In thousands)	Nine Months Ended	
	September 30,	September 30,
	2018	2017
Cash flows provided by operating activities:		
Net income	\$ 153,480	\$ 135,063
Adjustments to reconcile net income to net cash provided by operating activities:		
Share-based compensation	17,066	9,562
Provision for bad debts	8,669	13,351
Depreciation and amortization	31,783	40,467
Deferred income taxes	(13,551)	3,813
Loss on transaction, net of costs and asset impairment	12,605	
Other	1,411	1,751
Changes in assets and liabilities:		
Accounts receivable from GCU	(69,501)	
Accounts receivable	(7,784)	(14,827)
Prepaid expenses and other	(555)	(3,784)
Accounts payable	(11,938)	4,007
Accrued liabilities and employee related liabilities	(8,666)	6,710
Income taxes receivable/payable	(15,887)	8,156
Deferred rent	(189)	(271)
Deferred revenue	6,881	75,699
Student deposits	(7,288)	(9,770)
Net cash provided by operating activities	96,536	269,927
Cash flows used in investing activities:		
Capital expenditures	(90,152)	(75,604)
Purchases of land and building improvements related to off-site development	(330)	(10,152)
Disposition, net of cash	(131,550)	
Funding to GCU at closing in excess of required capital	(7,377)	
Repayment of excess funds by GCU	7,377	
Funding to GCU for capital expenditures	(12,803)	
Return of equity method investment		685
Purchases of investments	(31,455)	(76,630)
Proceeds from sale or maturity of investments	50,561	49,617
Net cash used in investing activities	(215,729)	(112,084)
Cash flows used in financing activities:		
Principal payments on notes payable and capital lease obligations	(5,076)	(5,102)

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Net borrowings from revolving line of credit		(25,000)
Repurchase of common shares including shares withheld in lieu of income taxes	(19,288)	(9,657)
Net proceeds from exercise of stock options	2,095	6,755
Net cash used in financing activities	(22,269)	(33,004)
Net (decrease) increase in cash and cash equivalents and restricted cash	(141,462)	124,839
Cash and cash equivalents and restricted cash, beginning of period	248,008	130,907
Cash and cash equivalents and restricted cash, end of period	\$ 106,546	\$ 255,746
Supplemental disclosure of cash flow information		
Cash paid for interest	\$ 738	\$ 1,633
Cash paid for income taxes	\$ 69,161	\$ 45,413
Supplemental disclosure of non-cash investing and financing activities		
Sale transaction to GCU through Secured Note financing	\$ 870,097	\$
Purchases of property and equipment included in accounts payable	\$ 924	\$ 6,437
Reclassification of capitalized costs adoption of ASC 606	\$ 9,015	\$
Reclassification of deferred revenue adoption of ASC 606	\$ 7,451	\$
Reclassification of tax effect within accumulated other comprehensive income	\$ 156	\$

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

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GRAND CANYON EDUCATION, INC.

Notes to Consolidated Financial Statements

(In thousands, except per share data)

(Unaudited)

1. Nature of Business

Grand Canyon Education, Inc. (together with its subsidiaries, the Company or GCE) is a publicly traded education services company. GCE provides a full array of support services in the post-secondary education sector and has developed significant technological solutions, infrastructure and operational processes to provide service in these areas on a large scale. GCE currently provides services to Grand Canyon University, an Arizona non-profit corporation (GCU), its client, that include technology and academic services, counseling services and support, marketing and communication services, and several back office services such as accounting, reporting, tax, human resources, and procurement services. On July 1, 2018 the Company consummated a transaction that impacted the nature of our business. See Note 2 to our consolidated financial statements for a full description of this transaction. The Company's wholly-owned subsidiaries were historically used to facilitate expansion of the university campus prior to the transaction.

GCU owns and operates a comprehensive regionally accredited university (the University) that offers over 230 graduate and undergraduate degree programs, emphases and certificates across nine colleges both online and on ground at its over 262 acre campus in Phoenix, Arizona, at leased facilities and at facilities owned by third party employers.

2. The Transaction

Asset Purchase Agreement and Related Agreements

On July 1, 2018, the Company consummated an Asset Purchase Agreement (the Asset Purchase Agreement) with GCU (formerly known as Gazelle University). Prior to the consummation of the transactions contemplated by the Asset Purchase Agreement (the Transaction), the Company operated the University.

Pursuant to the Asset Purchase Agreement:

The Company transferred to GCU the real property and improvements comprising the University campus as well as tangible and intangible academic and related operations and assets related to the University (the Transferred Assets), and GCU assumed liabilities related to the Transferred Assets. Accordingly, GCU now owns and operates the University. The Asset Purchase Agreement contains customary representations, warranties, covenants, agreements and indemnities.

The final purchase price that GCU paid for the Transferred Assets at closing (and after giving effect to a post-closing adjustment as provided in the Asset Purchase Agreement) was \$870,097. The final purchase price was equal to the book value of the tangible Transferred Assets as of July 1, 2018, plus \$1.00 for the

intangible Transferred Assets.

GCU paid the purchase price for the Transferred Assets by issuing to the Company a senior secured note (the Secured Note) that is governed by a credit agreement between the Company and GCU (the Credit Agreement). The Credit Agreement contains customary commercial credit terms, including affirmative and negative covenants applicable to GCU, and provides that the Secured Note bears interest at an annual rate of 6.0%, has a maturity date of June 30, 2025, and is secured by all of the assets of GCU. The Secured Note provides for GCU to make interest only payments during the term, with all principal and accrued and unpaid interest due at maturity and also provides that the Company will loan additional amounts to GCU to fund approved capital expenditures during the first three years of the term on the terms set forth therein.

In connection with the closing of the Asset Purchase Agreement, the Company and GCU entered into a long-term master services agreement (the Master Services Agreement) pursuant to which the Company provides identified technology and academic services, counseling services and support, marketing and communication services, and several back office services to GCU in return for 60% of GCU 's tuition and fee revenue. The Master Services Agreement has an initial term of fifteen (15) years, subject to renewal options, although GCU has the right to terminate the Master Services Agreement early after the later of seven (7) years or the payment in full of the Secured Note. If GCU were to terminate the Master Services Agreement early, then GCU would be required to pay the Company a termination fee equal to one-hundred percent (100%) of the fees paid in the trailing twelve (12) month period. If the Master Services Agreement were not renewed after the initial fifteen (15) year term, GCU would be required to pay the Company a non-renewal fee equal to fifty percent (50%) of the fees paid in the trailing twelve (12) month period.

As a result of the Transaction, effective July 1, 2018, various aspects of the Company 's operations changed in important ways. See Management 's Discussion and Analysis of Financial Condition and Results of Operations Change in the Structure of Our Operations.

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GRAND CANYON EDUCATION, INC.

Notes to Consolidated Financial Statements

(In thousands, except per share data)

(Unaudited)

Disposed Assets, previously Assets and Liabilities Held for Sale

The Company received Board approval to consummate the Transaction on June 28, 2018, and completed the Transaction on July 1, 2018. As a result, the Company determined that it had met the accounting requirements to classify the assets and liabilities to be transferred in the Transaction as assets and liabilities held for sale as of June 30, 2018. The assets and liabilities held for sale were sold as part of the Transaction on July 1, 2018. Accordingly, the following balances were transferred to GCU as of July 1, 2018:

Restricted cash and cash equivalents	\$ 97,443
Accounts receivable, net of allowance for doubtful accounts of \$6,093	9,780
Other assets	7,677
Property and equipment, net of accumulated depreciation of \$166,066	870,097
Total assets held for sale, current	\$ 984,997
Accrued and other liabilities	\$ 5,025
Student deposits	88,010
Deferred revenue	46,325
Note payable	79
Total liabilities held for sale, current	\$ 139,439

The Company received a Secured Note for the Transferred Assets. The Company also transferred cash equal to \$34,107 representing a working capital adjustment as part of the closing. Except for identified liabilities assumed by GCU, GCE retained responsibility for all liabilities of the business arising from pre-closing operations. For the nine months ended September 30, 2018 the Company had a loss of \$17,600, included in Loss on Transaction due to transaction costs of \$4,995 and an asset impairment of \$3,037 for the nine months ended September 30, 2018. In addition, the Company transferred to GCU cash of \$9,568 to fund a deferred compensation plan for GCU employees that were formerly GCE employees (the Transferred Employees) and that held unvested restricted stock of GCE that was forfeited upon the Transaction. Included in the university related expenses for the three months ended September 30, 2018 is \$7,880 of share-based compensation expense resulting from the modification and vesting of previously issued restricted stock grants held by Transferred Employees, employer tax expense of \$191 related to the share-based compensation modification, net of reversals of employee related liabilities that were not part of the Transferred Assets for the Transaction of \$1,502.

Variable Interest Entity and Related Party Considerations

ASC 810-10-15-17 provides scope exceptions to the variable interest entity analysis that include a not-for profit entity carve out. GCU is not a related party to the Company in accordance with ASC Topic 850. The following factors were considered:

Since GCU is a non-profit corporation, the Company has no ownership interest or voting rights in GCU.

GCU is a separate non-profit entity under the control of an independent board of trustees, none of whose members have ever served in a management or corporate board role at the Company. GCU's board of trustees has adopted bylaws and a related conflict of interest policy that, among other things, (i) prevents any trustee of GCU from attending any meeting, or voting on any matter, as to which such trustee has a conflict of interest, (ii) establishes a special committee of independent trustees to oversee on behalf of GCU all matters related to the Master Services Agreement and GCU's relationship with the Company, and (iii) prohibits any trustee from having any financial interest in, or role with, the Company. Accordingly, the Company's relationship with GCU, both pursuant to the Master Services Agreement and operationally, is no longer as owner and operator, but as a third party service provider to an independent customer. While the Company believes that its relationship with GCU will remain strong, GCU's board of trustees and management will have fiduciary and other duties that will require them to focus on the best interests of GCU and over time those interests could diverge from those of the Company.

Mr. Brian E. Mueller has served as the Chief Executive Officer of the Company since 2008 and the Chairman of the Board of the Company since 2017 and has also served as the President of the University since 2012. In connection with the Transaction, the Board of Directors of the Company and the board of trustees of GCU each independently determined that Mr. Mueller should retain those roles. Accordingly, Mr. Mueller remains the Chairman of the Board and Chief Executive Officer of the Company and continues to serve as the President of GCU. As noted above, however, Mr. Mueller is prohibited from serving on the board of trustees of GCU. Aside from Mr. Mueller, no other employee of GCU or GCE has a dual role in both organizations. A structure has been put in place that prevents Mr. Mueller from participating in operational matters involving the Company and GCU, including with respect to the Master Services Agreement.

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GRAND CANYON EDUCATION, INC.

Notes to Consolidated Financial Statements

(In thousands, except per share data)

(Unaudited)

The terms of the Master Services Agreement vest in GCU and its board of trustees full authority over decision making related to the day-to-day operations of GCU, including, without limitation, (i) selecting, hiring and firing its personnel, (ii) selecting and adopting academic programs and courses, (iii) establishing admission standards and admitting students, (iv) overseeing instruction, (v) setting credit and student performance requirements, (vi) determining graduation requirements, and (vii) conferring degrees. Per the terms of the MSA, GCE has no authority over GCU's day-to-day operations.

If GCU were to default under the Credit Agreement, the Company would be able to pursue assets of GCU, which are pledged as collateral for the Secured Note. However, the Company would not become the owner or operator of GCU.

There is no parent entity and subsidiary relationship between the Company and GCU.

The Company and GCU both engaged their own outside corporate counsel, outside regulatory counsel, and financial advisors to represent each party's interest during the Transaction.

Second Amendment to Credit Agreement

The Company is a party to a credit agreement with Bank of America, N.A. as Administrative Agent, and other lenders, dated December 21, 2012 and amended as of January 15, 2016. Effective July 1, 2018, the Company and the lenders amended the credit agreement (the Amendment). Under the terms of the Amendment, (a) the lenders released the collateral securing the Company's obligations under the credit agreement in order to enable the Company to consummate the Asset Purchase Agreement described above and modified certain financial and regulatory covenants to reflect the transactions described above, including the fact that the Company no longer operates a regulated educational institution, and (b) the Company (i) provided to the Administrative Agent cash collateral securing its remaining obligations under the credit agreement until such time as the Transaction has been approved by the U.S. Department of Education (the Department of Education), and (ii) agreed to collaterally assign its rights under the Asset Purchase Agreement, the Secured Note and the Master Services Agreement. The amount that is considered cash collateral is included as restricted cash on the consolidated balance sheet. The credit agreement, as amended by the Amendment, contains standard covenants, including covenants that, among other things, restrict the Company's ability to incur additional debt or make certain investments and that require the Company to maintain a certain financial condition.

3. Summary of Significant Accounting Policies

Principles of Consolidation

The consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries. Intercompany transactions have been eliminated in consolidation.

Unaudited Interim Financial Information

The accompanying unaudited interim consolidated financial statements of the Company have been prepared in accordance with U.S. generally accepted accounting principles and pursuant to the rules and regulations of the United States Securities and Exchange Commission and the instructions to Form 10-Q and Article 10, consistent in all material respects with those applied in its financial statements included in its Annual Report on Form 10-K for the fiscal year ended December 31, 2017. They do not include all of the information and footnotes required by U.S. generally accepted accounting principles for complete financial statements. Such interim financial information is unaudited but reflects all adjustments that in the opinion of management are necessary for the fair presentation of the interim periods presented. Interim results are not necessarily indicative of results for a full year. These consolidated financial statements should be read in conjunction with the Company's audited financial statements and footnotes included in its Annual Report on Form 10-K for the fiscal year ended December 31, 2017 from which the December 31, 2017 balance sheet information was derived. For purposes hereof, the term "university related revenue" refer to the Company's revenue from operations prior to the sale of the University to GCU, and the term "university related expenses" refers to the Company's expenses related to the operation of the University prior to the sale of the University to GCU and that are now the responsibility of GCU.

Restricted Cash and Cash Equivalents

A significant portion of the Company's university related revenue was received from students who participated in government financial aid and assistance programs. Prior to July 1, 2018, restricted cash and cash equivalents represented amounts received from the federal and state governments under various student aid grant and loan programs, such as Title IV. The Company received these funds subsequent to the completion of the authorization and disbursement process and held them for the benefit of the student. The Department of Education requires Title IV funds collected in advance of student billings to be restricted until the course begins. Prior to the Transaction, the Company recorded all of these amounts as a current asset in restricted cash and cash equivalents. The majority of these funds remained as restricted for an average of 60 to 90 days from the date of receipt. Restricted cash and cash equivalents at September 30, 2018 represents the cash collateral on the credit agreement.

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GRAND CANYON EDUCATION, INC.

Notes to Consolidated Financial Statements

(In thousands, except per share data)

(Unaudited)

Investments

The Company considers its investments in municipal bonds, mutual funds, municipal securities, certificates of deposit and commercial paper as available-for-sale securities. Available-for-sale securities are carried at fair value, determined using Level 1 and Level 2 of the hierarchy of valuation inputs, with the use of quoted market prices and inputs other than quoted prices that are observable for the assets, with unrealized gains and losses, net of tax, reported as a separate component of other comprehensive income. Unrealized losses considered to be other-than-temporary are recognized currently in earnings. Amortization of premiums, accretion of discounts, interest and dividend income and realized gains and losses are included in interest and other income.

Derivatives and Hedging

Derivative financial instruments are recorded on the balance sheet as assets or liabilities and re-measured at fair value at each reporting date. For derivatives designated as cash flow hedges, the effective portion of the gain or loss on the derivative is reported as a component of other comprehensive income and reclassified into earnings in the same period or periods during which the hedged transaction affects earnings. Gains and losses on the derivative representing either hedge ineffectiveness or hedge components excluded from the assessment of effectiveness are recognized in current earnings.

Derivative financial instruments enable the Company to manage its exposure to interest rate risk. The Company does not engage in any derivative instrument trading activity. Credit risk associated with the Company's derivative is limited to the risk that a derivative counterparty will not perform in accordance with the terms of the contract. Exposure to counterparty credit risk is considered low because these agreements have been entered into with institutions with Aa or higher credit ratings, and they are expected to perform fully under the terms of the agreements.

On February 27, 2013, the Company entered into an interest rate corridor to manage its 30 Day LIBOR interest exposure related to its variable rate debt. The fair value of the interest rate corridor instrument as of September 30, 2018 and December 31, 2017 was \$801 and \$509, respectively, which is included in other assets. The fair value of the derivative instrument was determined using a hypothetical derivative transaction and Level 2 of the hierarchy of valuation inputs. This derivative instrument was originally designated as a cash flow hedge of variable rate debt obligations. The adjustment of \$330 and \$169 for the nine months ended September 30, 2018 and 2017, respectively, for the effective portion of the gains and losses on the derivatives is included as a component of other comprehensive income, net of taxes.

The interest rate corridor instrument reduces variable interest rate risk starting March 1, 2013 through December 20, 2019 with a notional amount of \$61,667 as of September 30, 2018. The corridor instrument's terms permit the Company to hedge its interest rate risk at several thresholds; the Company pays variable interest monthly based on the 30 Day LIBOR rates until that index reaches 1.5%. If 30 Day LIBOR is equal to 1.5% through 3.0%, the Company

pays 1.5%. If 30 Day LIBOR exceeds 3.0%, the Company pays actual 30 Day LIBOR less 1.5%.

As of September 30, 2018, no derivative ineffectiveness was identified. Any ineffectiveness in the Company's derivative instrument designated as a hedge is reported in interest expense in the income statement. At September 30, 2018, the Company expects to reclassify gains or losses on derivative instruments from accumulated other comprehensive income (loss) into earnings during the next 12 months as the derivative instrument expires in December 2019.

Fair Value of Financial Instruments

The carrying value of cash and cash equivalents, investments, accounts receivable, accounts payable and accrued compensation and benefits and accrued liabilities expenses approximate their fair value based on the liquidity or the short-term maturities of these instruments. The carrying value of notes receivable, non-current approximates fair value as the Secured Note resulted from the Transaction and was negotiated at fair market value. The carrying value of notes payable approximates fair value as it is based on variable rate index. Derivative financial instruments are carried at fair value, determined using Level 2 of the hierarchy of valuation inputs as defined in the FASB Accounting Standards Codification (Codification), with the use of inputs other than quoted prices that are observable for the asset or liability.

The fair value of investments, primarily municipal securities, was determined using Level 2 of the hierarchy of valuation inputs, with the use of inputs other than quoted prices that are observable for the assets. The unit of account used for valuation is the individual underlying security. The municipal securities are comprised of city and county bonds related to schools, water and sewer, utilities, transportation, healthcare and housing.

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GRAND CANYON EDUCATION, INC.

Notes to Consolidated Financial Statements

(In thousands, except per share data)

(Unaudited)

Revenue Recognition*University related revenue prior to July 1, 2018*

On January 1, 2018, the Company adopted Revenue from Contracts with Customers using the modified retrospective method applied to all contracts. Prior to the Transaction on July 1, 2018, net revenues consisted primarily of tuition, net of scholarships, and fees derived from courses taught by the University online, on ground, and at facilities it leased or those of employers, as well as from related educational resources that the University provided to its students, such as access to online materials. Tuition revenue was recognized pro-rata over the applicable period of instruction. A contract was entered into with a student and covered a course or semester. Revenue recognition occurred once a student started attending a course. The Company also charged online students an upfront learning management fee, which was deferred and recognized over the initial course. The Company had no costs that were capitalized to obtain or to fulfill a contract with a customer. Ancillary revenues included housing and fee revenues that were recognized over the period the services were provided and also included revenues from sales and services such as food and beverage, merchandise, hotel, golf and arena events that were recognized as sales occurred or services were performed as these services were transferred at a point in time. For the six months ended June 30, 2018 and the nine months ended September 30, 2017, the Company's revenue was reduced by approximately \$101,176 and \$135,630, respectively, as a result of scholarships that the Company offered to students. Sales tax collected from students is excluded from net revenues. Collected but unremitted sales tax is included as an accrued liability in our consolidated balance sheet.

The following table presents our revenues disaggregated by the nature of transfer of services for the six months ended June 30, 2018:

Tuition revenues	\$ 522,430
Ancillary revenues (housing, meals, fees, golf, hotel, arena, other)	91,245
Total revenues	613,675
Scholarships	(101,176)
Net Revenues	\$ 512,499

The Company's receivables represented unconditional rights to consideration from its contracts with students; accordingly, students were not billed until they started attending a course and the revenue recognition process had

commenced. Once a student had been invoiced, payment was due immediately. Included in each invoice to the student were all educational related items including tuition, net of scholarships, housing, educational materials, fees, etc. The Company did not have any contract assets. The Company's contract liabilities were reported as deferred revenue and student deposits in the consolidated balance sheets. Deferred revenue and student deposits in any period represented the excess of tuition, fees, and other student payments received as compared to amounts recognized as revenue on the consolidated income statement and were reflected as current liabilities in the accompanying consolidated balance sheets. The Company's education programs had starting and ending dates that differ from its fiscal quarters. Therefore, at the end of each fiscal quarter, a portion of revenue from these programs was not yet earned. The majority of the University's traditional ground students did not attend courses during the summer months (May through August), which affected our results for our second and third fiscal quarters.

The Company had identified a performance obligation associated with the provision of its educational instruction and other educational services, housing services, and other academic related services and used the output measure for recognition as the period of time over which the services were provided to our students. The Company had identified performance obligations related to its hotel, golf course, restaurants, sale of branded promotional items and other ancillary activities and recognized revenue at the point in time goods or services were provided to its customers. The Company maintained an institutional tuition refund policy, which provided for all or a portion of tuition to be refunded if a student withdrew during stated refund periods. Certain states in which students reside impose separate, mandatory refund policies, which overrode the Company's policy to the extent in conflict. If a student withdrew at a time when only a portion, or none of the tuition was refundable, then in accordance with its revenue recognition policy, the Company continued to recognize the tuition that was not refunded pro-rata over the applicable period of instruction. The Company did not record revenue on amounts that may be refunded. However, for students that had taken out financial aid to pay their tuition and for which a return of such money to the Department of Education under Title IV was required as a result of his or her withdrawal, the Company reassessed collectability for these students each quarter for the estimated revenue that will be returned and recognized the revenue in future periods when payment was received. The Company had elected the short-term contract exemption with respect to its performance obligations under its contracts with students as all such contracts had original terms of less than one year.

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(In thousands, except per share data)

(Unaudited)

Service revenue commenced July 1, 2018

Starting July 1, 2018, the Company generates all of its revenue through the Master Services Agreement, pursuant to which the Company provides identified technology and academic services, counseling services and support, marketing and communication services, and several back office services to GCU in return for 60% of GCU's tuition and fee revenue. Effective July 1, 2018, the Company adopted *Revenue from Contracts with Customers* applied to our Master Service Agreement, our only revenue-producing contract, as an education service provider.

The Company's contract with GCU has an initial 15 year term, subject to renewal options, although GCU has the right to terminate the Master Services Agreement early after the later of seven (7) years or the payment in full of the Secured Note. Refer to Note 2 for further discussion on the fees associated with early termination or non-renewal by GCU. The Company's contract has a single performance obligation, as the promises to provide the identified services are not distinct within the context of the Master Services Agreement. The single performance obligation is delivered as our client receives and consumes benefits, which occurs ratably over the service period. Service revenue is recognized over time using the output method of measuring progress towards complete satisfaction of the single performance obligation. The output method provides a faithful depiction of the performance toward complete satisfaction of the performance obligation and can be tied to the time elapsed which is consumed evenly over the month and is a direct measurement of the value provided to our client. The service fees received from our client over the term of the agreement are variable in nature in that they are dependent upon the number of students attending the University and revenues generated from those students during the service period. Due to the variable nature of the consideration over the life of the service arrangement, the Company considered forming an expectation of the variable consideration to be received over the service life of this one performance obligation. However, since the performance obligation represents a series of distinct services, the Company will recognize the variable consideration that becomes known and billable each month because these fees related to the distinct service period (month) in which the fees are earned. The Company meets the criteria in the standard and will exercise the practical expedient and not disclose the aggregate amount of the transaction price allocated to the single performance obligation that is unsatisfied as of the end of the reporting period. The Company does not disclose the value of unsatisfied performance obligations because the directly allocable variable consideration is allocated entirely to a wholly unsatisfied promise to transfer a service that forms part of a single performance obligation. The service fees are calculated and settled monthly with GCU, resulting in a settlement duration of less than one year. There are no refunds or return rights under the Master Services Agreement.

The Company's receivables represent unconditional rights to consideration from our contract with GCU. Accounts receivable, net is stated at net realizable value, and the Company utilizes the allowance method to provide for doubtful accounts based on its evaluation of the collectability of the amounts due. There are no unbilled revenue amounts included in our accounts receivable. There have been no amounts written off and no reserves established as of September 30, 2018. The Company receives service revenue payments monthly. The Company will continue to review and revise its allowance methodology based on historical collection experience.

The Company does not have any contract assets or contract liabilities as the Company calculates the service fee and bills its client on the last day of each month. The Company has no costs that are capitalized to obtain or to fulfill a contract with a customer.

Prepaid Royalty

In connection with its February 2004 acquisition of the assets of Grand Canyon University from a non-profit foundation, the Company recorded a future royalty payment obligation that was included in the Prepaid Royalty in the accompanying consolidated balance sheet, which was being amortized over a 20 year period. This asset was to be expensed over the periods that online education revenues were earned. At the completion of the Transaction on July 1, 2018, the remaining prepaid royalty assets were deemed impaired and \$3,037 was expensed and included in Loss on Transaction in the consolidated income statement.

Internally Developed Technology

The Company capitalizes certain costs related to internal-use software, primarily consisting of direct labor associated with creating the software. Software development projects generally include three stages: the preliminary project stage (all costs are expensed as incurred), the application development stage (certain costs are capitalized and certain costs are expensed as incurred) and the post-implementation or operation stage (all costs are expensed as incurred). Costs capitalized in the application development stage include costs of design, coding, integration, and testing of the software developed. Capitalization of costs requires judgment in determining when a project has reached the application development stage and the period over which we expect to benefit from the use of that software. Once the software is placed in service, these costs are amortized over the estimated useful life of the software, which is generally three years. These assets are a component of our property and equipment, net in our consolidated balance sheet.

Long-Lived Assets (other than goodwill)

The Company evaluates the recoverability of its long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to undiscounted future net cash flows expected to be generated by the assets. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds the fair value of the assets.

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Financial Statement Presentation

On July 1, 2018 the Company consummated the Transaction, which impacted the nature of its business. See Note 2 to our consolidated financial statements for a full description of the Transaction. GCE now provides services to GCU, its client, that include technology and academic services, counseling services and support, marketing and communication services, and several back office services such as accounting, reporting, tax, human resources, and procurement services. The Company made changes in its presentation of operating expenses and reclassified prior periods to conform to the current presentation. The Company determined that these changes would provide more meaningful information as this new presentation provides transparency for costs that will be incurred as a service provider and costs that will not reoccur in the future as they are related to university expenses that were transferred to GCU in the Transaction.

Technical and Academic Services

Technical and academic services (previously primarily a component of instructional costs and services) consist primarily of costs related to ongoing maintenance of educational infrastructure, including online course delivery and management, student records, assessment, customer relations management and other internal administrative systems. This also includes costs to provide support for curriculum and new program development, support for faculty training and development, technical support and assistance with state compliance. This expense category includes salaries, benefits and share-based compensation, information technology costs, curriculum and new program development costs (which are expensed as incurred) and other costs associated with these support services. This category also includes an allocation of depreciation, amortization, rent, and occupancy costs attributable to the provision of these services, primarily at the Company's Phoenix, Arizona location.

Counseling Services and Support

Counseling services and support (previously primarily components of instructional costs and services and admissions advisory related expenses) consist primarily of costs including team-based counseling and other support to prospective and current students as well as financial aid processing. This expense category includes salaries, benefits and share-based compensation, and other costs such as dues, fees and subscriptions and travel costs. This category also includes an allocation of depreciation, amortization, rent, and occupancy costs attributable to the provision of these services, primarily at the Company's Phoenix, Arizona location.

Marketing and Communication

Marketing and communication includes lead acquisition, digital communication strategies, brand identity advertising, media planning and strategy, video, data science and analysis, marketing to potential students and other promotional and communication services. This category was primarily from our historical captions of advertising and marketing

and promotional. This expense category includes salaries, benefits and share-based compensation for marketing and communication personnel, brand advertising, marketing leads and other promotional and communication expenses. This category also includes an allocation of depreciation, amortization, rent, and occupancy costs attributable to the provision of these services, primarily at the Company's Phoenix, Arizona location. Advertising costs are expensed as incurred.

General and Administrative

General and administrative expenses include salaries, benefits and share-based compensation of employees engaged in corporate management, finance, human resources, compliance, and other corporate functions. This category also includes an allocation of depreciation, amortization, rent, and occupancy costs attributable to the provision of these services, primarily at the Company's Phoenix, Arizona location.

University related expenses

University related expenses (previously primarily instructional costs and services) represent the costs that were transferred to GCU in the Transaction and that are no longer incurred by the Company.

We have reclassified our operating expenses for prior periods to conform to the above disaggregation and revisions to our presentation. There were no changes to total operating expenses or operating income as a result of these reclassifications. The following table presents our operating expenses as previously reported and as reclassified on our Consolidated Income Statement for each of the quarters in 2017 and the first two quarters of 2018.

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	2017			
	First Quarter		Second Quarter As Reported	Second Quarter As Reclassified
	As Reported	First Quarter As Reclassified		
Costs and expenses:				
Technology and academic services		10,381		10,220
Counseling services and support		46,312		45,970
Marketing and communication		27,309		27,426
General and administrative	9,941	7,033	10,058	5,806
University related expenses		80,543		73,791
Instructional costs and services	102,574		95,030	
Admissions advisory and related	31,972		31,085	
Advertising	24,631		24,776	
Marketing and promotional	2,460		2,264	
Total costs and expenses	171,578	171,578	163,213	163,213

	2017			
	Third Quarter		Fourth Quarter As Reported	Fourth Quarter As Reclassified
	As Reported	Third Quarter As Reclassified		
Costs and expenses:				
Technology and academic services		10,494		10,739
Counseling services and support		46,100		50,213
Marketing and communication		28,130		26,227
General and administrative	12,915	8,343	10,845	5,975
University related expenses		83,450		86,356
Loss on transaction				562
Instructional costs and services	104,303		108,933	
Admissions advisory and related	31,426		34,061	
Advertising	25,523		23,678	
Marketing and promotional	2,350		2,555	
Total costs and expenses	176,517	176,517	180,072	180,072

2018

	First Quarter		Second Quarter	Second Quarter
	As	First Quarter	As Reported	Second Quarter
	Reported	As Reclassified		As Reclassified
Costs and expenses:				
Technology and academic services		10,697		10,678
Counseling services and support		50,747		50,838
Marketing and communication		28,527		30,095
General and administrative	11,309	7,419	11,969	5,762
University related expenses		87,649		79,517
Loss on transaction		550		1,440
Instructional costs and services	111,027		102,237	
Admissions advisory and related	34,854		34,254	
Advertising	25,715		27,602	
Marketing and promotional	2,684		2,268	
Total costs and expenses	185,589	185,589	178,330	178,330

Commitments and Contingencies

The Company accrues for contingent obligations when it is probable that a liability has been incurred and the amount is reasonably estimable. When the Company becomes aware of a claim or potential claim, the likelihood of any loss exposure is assessed. If it is probable that a loss will result and the amount of the loss is estimable, the Company records a liability for the estimated loss. If the loss is not probable or the amount of the potential loss is not estimable, the Company will disclose the claim if the likelihood of a potential loss is reasonably possible and the amount of the potential loss could be material. Estimates that are particularly sensitive to future changes include tax, legal, and other regulatory matters, which are subject to change as events evolve, and as additional information becomes available during the administrative and litigation process. The Company expenses legal fees as incurred.

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Concentration of Credit Risk

The Company believes the credit risk related to cash equivalents and investments is limited due to its adherence to an investment policy that requires investments to have a minimum BBB rating, depending on the type of security, by one major rating agency at the time of purchase. All of the Company's cash equivalents and investments as of September 30, 2018 and December 31, 2017 consist of investments rated BBB or higher by at least one rating agency. Additionally, the Company utilizes more than one financial institution to conduct initial and ongoing credit analysis on its investment portfolio to monitor and lower the potential impact of market risk associated with its cash equivalents and investment portfolio. The Company is also subject to credit risk for its accounts receivable balance. The Company has not experienced any losses on receivables to date. To manage accounts receivable risk, the Company maintains an allowance for doubtful accounts, if needed. Our dependence on one customer subjects us to the risk that declines in our customer's operations would result in a sustained reduction in revenues for the Company.

Use of Estimates

The preparation of consolidated financial statements in conformity with U.S. generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts in the consolidated financial statements and accompanying notes. Actual results could differ from those estimates.

Segment Information

The Company operates as a single educational services company using a core infrastructure that serves the curriculum and educational delivery needs of its client, GCU. The Company's Chief Executive Officer manages the Company's operations as a whole and no expense or operating income information is generated or evaluated on any component level.

Accounting Pronouncements Adopted in 2018

In May 2014, the FASB issued *Revenue from Contracts with Customers*, as amended. The standard is a comprehensive new revenue recognition model that requires revenue to be recognized in a manner to depict the transfer of goods or services to a customer at an amount that reflects the consideration expected to be received in exchange for those goods or services. The accounting guidance also requires additional disclosure about the nature, amount, timing and uncertainty of revenue and cash flows arising from customer contracts, including significant judgements and changes in judgements and assets recognized from costs incurred to obtain or fulfill a contract. The Company adopted this new standard on January 1, 2018, using the modified retrospective method applied to all contracts. The adoption of this guidance did not have a material impact on the Company's financial condition, results of operations or statement of cash flows. The Company elected the short-term contract exemption with respect to disclosures associated with its performance obligations as all performance obligations as of the end of any reporting

period have original terms of less than a year. The cumulative effect for the Company upon adoption of this new standard was \$1,174, net of tax. The adoption impact resulted from the removal of \$9,015 of costs that were direct and incremental previously capitalized for online students, and the removal of deferred revenue from an upfront learning fee of \$7,451. These fees are no longer capitalized and amortized over the average expected term of a student. The fee is now amortized over the first course for the online student.

In January 2016, the FASB issued *Financial Instruments Overall: Recognition and Measurement of Financial Assets and Financial Liabilities*. The standard addresses certain aspects of recognition, measurement, presentation, and disclosure of financial instruments. Most prominent among the amendments is the requirement for changes in the fair value of equity investments, with certain exceptions, to be recognized through net income rather than other comprehensive income (OCI). This standard is effective for fiscal years, and interim periods within those years, beginning after December 15, 2017, and early adoption is not permitted. Accordingly, the standard was effective for us as of January 1, 2018. The adoption of this guidance did not have a material impact on the Company's financial condition, results of operations or statement of cash flows.

In May 2017, the FASB issued *Compensation Stock Compensation Scope of Modification Accounting*. This standard provides guidance about which changes to the terms or conditions of a share-based payment award require an entity to apply modification accounting. This standard was effective for fiscal years beginning after December 15, 2017. Early adoption was permitted, including adoption in any interim period. Accordingly, the standard was adopted by us as of July 1, 2018. The vesting conditions for approximately 100 former GCE employees who became GCU employees upon the closing of the Transaction, were accelerated contingent upon the closing of the Transaction. As a result, the incremental share-based compensation expense from the modification on 82 restricted stock awards for the accelerated vesting date was \$7,880 and is included in the university related expenses in the consolidated income statement.

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(In thousands, except per share data)

(Unaudited)

In February 2018, the FASB issued *Income Statement Reporting Comprehensive Income*. This standard allows a reclassification from accumulated other comprehensive income to retained earnings for stranded tax effects resulting from the Tax Cuts and Jobs Act. Elimination of the stranded tax effects resulting from the Tax Cuts and Jobs Act and will improve the usefulness of information reported to financial statement users. This standard is effective for fiscal years beginning after December 15, 2018, and interim periods within those fiscal years. Early adoption is permitted, including adoption in any interim period. Accordingly, the standard was adopted by us as of April 1, 2018. The adoption of this guidance did not have a material impact on the Company's financial condition, results of operations or statement of cash flows.

Recent Accounting Pronouncements

In February 2016, the FASB issued *Leases*. The standard establishes a right-of-use (ROU) model that requires a lessee to recognize a ROU asset and a lease liability on the balance sheet for all leases with lease terms longer than 12 months. Leases will be classified as either finance or operating, with classification affecting the pattern of expense recognition in the income statement. This standard is effective for fiscal years, and interim periods within those years, beginning after December 15, 2018, and early adoption is permitted. Accordingly, the standard is effective for us on January 1, 2019 using a modified retrospective transition approach. A modified retrospective transition approach is required for lessees for capital and operating leases existing at, or entered into after, the beginning of the earliest comparative period presented in the financial statements, with certain practical expedients available. The Company continues to evaluate the impact that the future adoption of this standard will have on our consolidated financial statements and we believe the adoption will slightly increase our assets and liabilities, and will increase our financial statement disclosures.

In August 2017, the FASB issued *Targeted Improvements to Accounting for Hedging Activities*. This standard targets improvements in the hedge relationship documentation, testing and disclosures for derivatives. This standard is effective for fiscal years, and interim periods within those years, beginning after December 15, 2018. Early adoption is permitted for fiscal years and interim period within those years, beginning in August 2017. Accordingly, the standard is effective for us on January 1, 2019 and we are currently evaluating the impact that the standard will have on our consolidated financial statements.

The Company has determined that no other recent accounting pronouncements apply to its operations or could otherwise have a material impact on its consolidated financial statements.

4. Investments

The following is a summary of investments as of September 30, 2018 and December 31, 2017. The Company considered all investments as available for sale.

	As of September 30, 2018			
	Adjusted Cost	Gross Unrealized Gains	Gross Unrealized (Losses)	Estimated Fair Value
Municipal securities	\$ 69,192	\$	\$ (438)	\$ 68,754
Total investments	\$ 69,192	\$	\$ (438)	\$ 68,754

	As of December 31, 2017			
	Adjusted Cost	Gross Unrealized Gains	Gross Unrealized (Losses)	Estimated Fair Value
Municipal securities	\$ 84,768	\$	\$ (409)	\$ 84,359
Certificates of Deposit	\$ 4,915	\$	\$ (3)	\$ 4,912
Total investments	\$ 89,683	\$	\$ (412)	\$ 89,271

The cash flows of municipal securities are backed by the issuing municipality's credit worthiness. All municipal securities are due in one year or less as of September 30, 2018. For the nine months ended September 30, 2018, the net unrealized losses on available-for-sale securities was \$329, net of taxes.

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5. Net Income Per Common Share

Basic earnings per common share is calculated by dividing net income available to common stockholders by the weighted average number of common shares outstanding for the period. Diluted earnings per common share reflects the assumed conversion of all potentially dilutive securities, consisting of stock options and restricted stock awards, for which the estimated fair value exceeds the exercise price, less shares which could have been purchased with the related proceeds, unless anti-dilutive. For employee equity awards, repurchased shares are also included for any unearned compensation adjusted for tax. The table below reflects the calculation of the weighted average number of common shares outstanding, on an as if converted basis, used in computing basic and diluted earnings per common share.

	Three Months Ended		Nine Months	
	September 30,		Ended	
	2018	2017	September 30,	2017
Denominator:				
Basic weighted average shares outstanding	47,682	47,316	47,592	47,083
Effect of dilutive stock options and restricted stock	740	976	837	1,114
Diluted weighted average shares outstanding	48,422	48,292	48,429	48,197

Diluted weighted average shares outstanding excludes the incremental effect of unvested restricted stock and shares that would be issued upon the assumed exercise of stock options in accordance with the treasury stock method. For the nine months ended September 30, 2018 and 2017, approximately 0 and 3, respectively, of the Company's stock options and restricted stock awards outstanding were excluded from the calculation of diluted earnings per share as their inclusion would have been anti-dilutive. These options and restricted stock awards could be dilutive in the future.

6. Allowance for Doubtful Accounts

	Balance at	Charged to	Deductions⁽¹⁾	Transfers⁽²⁾	Balance at
	Beginning	Expense			End of
	of				Period
	Period				
Nine months ended September 30, 2018 ⁽²⁾	\$ 5,907	8,669	(8,483)	(6,093)	\$ 0

Nine months ended September 30, 2017 \$ 5,918 13,351 (12,978) \$ 6,291

(1) Deductions represent accounts written off, net of recoveries.

(2) Allowance was transferred to GCU with other educational assets and liabilities on July 1, 2018. See Note 2.

7. Property and Equipment

Property and equipment consist of the following:

	September 30, 2018	December 31, 2017
Land	\$ 5,579	\$ 160,126
Land improvements	2,242	25,630
Buildings	51,409	595,384
Buildings and leasehold improvements	9,564	117,460
Equipment under capital leases		5,937
Computer equipment	82,974	116,477
Furniture, fixtures and equipment	4,874	63,470
Internally developed software	37,933	36,173
Other		1,176
Construction in progress	2,695	32,390
	197,270	1,154,223
Less accumulated depreciation and amortization	(86,362)	(231,939)
Property and equipment, net	\$ 110,908	\$ 922,284

8. Commitments and Contingencies

Legal Matters

From time to time, the Company is a party to various lawsuits, claims, and other legal proceedings that arise in the ordinary course of business, some of which are covered by insurance. When the Company is aware of a claim or potential claim, it assesses the likelihood of any loss or exposure. If it is probable that a loss will result and the amount of the loss can be reasonably estimated, the

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Company records a liability for the loss. If the loss is not probable or the amount of the loss cannot be reasonably estimated, the Company discloses the nature of the specific claim if the likelihood of a potential loss is reasonably possible and the amount involved could be material. With respect to the majority of pending litigation matters, the Company's ultimate legal and financial responsibility, if any, cannot be estimated with certainty and, in most cases, any potential losses related to those matters are not considered probable.

Upon resolution of any pending legal matters, the Company may incur charges in excess of presently established reserves. Management does not believe that any such charges would, individually or in the aggregate, have a material adverse effect on the Company's financial condition, results of operations or cash flows.

Tax Reserves, Non-Income Tax Related

From time to time the Company has exposure to various non-income tax related matters that arise in the ordinary course of business. The Company reserve is not material for tax matters where its ultimate exposure is considered probable and the potential loss can be reasonably estimated.

9. Income Taxes

The Company has deferred tax assets and liabilities that reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. As a result of the Transaction, discussed in Note 2, significant changes were recorded with respect to deferred tax assets and liabilities.

Significant components of the Company's deferred income tax assets and liabilities, included in Deferred income taxes, non-current on the consolidated balance sheets are as follows:

	As of September 30, 2018	As of December 31, 2017
Deferred tax assets:		
Share-based compensation	\$ 2,729	\$ 4,201
Employee compensation	758	950
Allowance for doubtful accounts	155	1,685
Deferred tuition revenue	147	1,294
Deferred scholarship		618
Intangibles		590
State taxes	713	985

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Other	204	526
Deferred tax assets	4,706	10,849
Deferred tax liability:		
Property and equipment	(8,335)	(28,028)
Goodwill	(762)	(762)
Other	(30)	(421)
Deferred tax liability	(9,127)	(29,211)
Net deferred tax liability	\$ (4,421)	\$ (18,362)

The net deferred tax liability on the accompanying consolidated balance sheet is comprised of the following:

	As of September 30, 2018	As of December 31, 2017
Deferred income taxes, current	\$ 1,744	\$ 5,214
Deferred income taxes, non-current	(6,165)	(23,576)
Net deferred tax liability	\$ (4,421)	\$ (18,362)

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10. Share-Based Compensation

Incentive Plan

Prior to June 2017, the Company made grants of restricted stock and stock options under its 2008 Equity Incentive Plan (the 2008 Plan). In January 2017, the Board of Directors of the Company approved, and at the Company's 2017 annual meeting of stockholders held on June 14, 2017, the Company's stockholders adopted a 2017 Equity Incentive Plan (the 2017 Plan) under which a maximum of 3,000 shares may be granted. As of September 30, 2018, 1,910 shares were available for grants under the 2017 Plan. All grants of equity incentives made after June 2017 will be made from the 2017 Plan.

Restricted Stock

During the nine months ended September 30, 2018, the Company granted 160 shares of common stock with a service vesting condition to certain of its executives, officers, faculty and employees. The restricted shares have voting rights and vest in five annual installments of 20%, with this first installment vesting in March of the calendar year following the date of grant (the first vesting date) and on each of the four anniversaries of the first vesting date. Upon vesting, shares will be held in lieu of taxes equivalent to the minimum statutory tax withholding required to be paid when the restricted stock vests. During the nine months ended September 30, 2018, the Company withheld 151 shares of common stock in lieu of taxes at a cost of \$15,153 on the restricted stock vesting dates. In June 2018, following the annual stockholders meeting, the Company granted 3 shares of common stock under the 2017 Plan to the non-employee members of the Company's Board of Directors. The restricted shares granted to these directors have voting rights and vest on the earlier of (a) the one year anniversary of the date of grant or (b) immediately prior to the following year's annual stockholders meeting. In conjunction with the Transaction, the Compensation Committee of the Company's Board of Directors decided to modify the vesting condition for certain restricted stock awards for approximately 100 Transferred Employees who transferred employment from GCE to GCU, with the acceleration being contingent upon the closing of the Transaction on July 1, 2018. Refer to Note 2 for further discussion on the Transaction. As a result, the incremental share-based compensation expense from the modification on 82 restricted stock awards for the accelerated vesting date was \$7,880 and is included in the university related expenses in the consolidated income statement. Additionally, the Company transferred cash to GCU totaling \$9,568 to fund a deferred compensation plan in an amount equal to the value of the 86 shares forfeited by the Transferred Employees at the closing of the Transaction. This amount is included in the loss on transaction in the consolidated income statement.

A summary of the activity related to restricted stock granted under the Company's Incentive Plan since December 31, 2017 is as follows:

	Total Shares	Weighted Average Grant Date Fair Value per Share
Outstanding as of December 31, 2017	776	\$ 49.16
Granted	163	\$ 92.34
Vested	(384)	\$ 65.57
Forfeited, canceled or expired	(94)	\$ 71.68
Outstanding as of September 30, 2018	461	\$ 63.27

Stock Options

During the nine months ended September 30, 2018, no options were granted. A summary of the activity since December 31, 2017 related to stock options granted under the Company's Incentive Plan is as follows:

	Total Shares	Weighted Average Exercise Price per Share	Weighted Average Remaining Contractual Term (Years)	Aggregate Intrinsic Value \$(1)
Outstanding as of December 31, 2017	694	\$ 17.31		
Granted		\$		
Exercised	(130)	\$ 16.07		
Forfeited, canceled or expired		\$		
Outstanding as of September 30, 2018	564	\$ 17.60	2.03	\$ 53,657
Exercisable as of September 30, 2018	564	\$ 17.60	2.03	\$ 53,657

- (1) Aggregate intrinsic value represents the value of the Company's closing stock price on September 28, 2018 (\$112.80) in excess of the exercise price multiplied by the number of shares underlying options outstanding or exercisable, as applicable.

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GRAND CANYON EDUCATION, INC.

Notes to Consolidated Financial Statements

(In thousands, except per share data)

(Unaudited)

Share-based Compensation Expense

The table below outlines share-based compensation expense for the nine months ended September 30, 2018 and 2017 related to restricted stock and stock options granted:

	2018	2017
Technical and academic services	\$ 1,195	\$ 1,160
Counseling support and services	3,707	3,566
Marketing and communication	40	19
General and administrative	2,530	2,535
University related expenses	9,594	2,282
Share-based compensation expense included in operating expenses	17,066	9,562
Tax effect of share-based compensation	(4,267)	(3,825)
Share-based compensation expense, net of tax	\$ 12,799	\$ 5,737

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Item 2. 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 in conjunction with the financial statements and related notes that appear elsewhere in this report.

Forward-Looking Statements

This Quarterly Report on Form 10-Q, including Item 2, *Management's Discussion and Analysis of Financial Condition and Results of Operations*, contains certain forward-looking statements within the meaning of Section 27A of Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. These forward-looking statements include, without limitation, statements regarding: the Transaction; proposed new programs; statements as to whether regulatory developments or other matters may or may not have a material adverse effect on our financial position, results of operations, or liquidity; statements concerning projections, predictions, expectations, estimates, or forecasts as to our business, financial and operational results, and future economic performance; and statements of management's goals and objectives and other similar expressions concerning matters that are not historical facts. Words such as may, should, could, would, predicts, potential, continues to anticipate, future, intends, plans, believes, estimates and similar expressions, as well as statements in future identify forward-looking statements.

Forward-looking statements should not be read as a guarantee of future performance or results, and will not necessarily be accurate indications of the times at, or by, which such performance or results will be achieved. Forward-looking statements are based on information available at the time those statements are made or management's good faith belief as of that time with respect to future events, and are subject to risks and uncertainties that could cause actual performance or results to differ materially from those expressed in or suggested by the forward-looking statements. Important factors that could cause such differences include, but are not limited to:

the failure of the Company to operate successfully as a third party service provider to GCU, and GCU's failure to operate the University as successfully as it was previously operated by the Company;

the occurrence of any event, change or other circumstance that could give rise to the termination of any of the key Transaction agreements;

our failure to comply with the extensive regulatory framework applicable to us either directly as a third party service provider or indirectly through our university client, including Title IV of the Higher Education Act and the regulations thereunder, state laws and regulatory requirements, and accrediting commission requirements;

the ability of our university client's students to obtain federal Title IV funds, state financial aid, and private financing;

potential damage to our reputation or other adverse effects as a result of negative publicity in the media, in the industry or in connection with governmental reports or investigations or otherwise, affecting us or other

companies in the education services sector;

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