

**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 EXCHANGE ACT OF 1934**  
For the quarterly period ended **June 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 001-33601

**GlobalSCAPE, Inc.**

(Exact Name of Registrant as Specified in its Charter)

**Delaware**

State or Other Jurisdiction of  
Incorporation or Organization

**74-2785449**

I.R.S. Employer Identification No.

**4500 Lockhill-Selma, Suite 150**

**San Antonio, Texas**

Address of Principal Executive Offices

**78249**

Zip Code

Registrant's Telephone Number, Including Area Code

**210-308-8267**

\_\_\_\_\_  
Former Name, Former Address and Former Fiscal Year, if Changed Since Last Report

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 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  No

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

Large accelerated filer

Non-accelerated filer  (Do not check if a smaller reporting company)

Emerging growth company

Accelerated filer

Smaller reporting 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 Act). Yes  No

APPLICABLE ONLY TO ISSUERS INVOLVED IN BANKRUPTCY PROCEEDINGS DURING THE PRECEDING FIVE YEARS:

Indicate by check mark whether the registrant has filed all documents and reports required to be filed by Section 12, 13 or 15(d) of the Securities Exchange Act of 1934 subsequent to the distribution of securities under a plan confirmed by a court. Yes  No

APPLICABLE ONLY TO CORPORATE ISSUERS

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date. As of July 31, 2018 there were 21,873,131 shares of common stock outstanding.

**GlobalSCAPE, Inc.**  
**Quarterly Report on Form 10-Q**  
**For the Quarter ended June 30, 2018**  
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## Preliminary Notes

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Other trademarks and trade names in this Quarterly Report are the property of their respective owners.

In this report, we use the following terms:

“BYOL” means bring your own license.

“Cloud” or “cloud computing” refers to pooled computing resources, delivered on-demand, over the Internet. In the same manner that electricity is delivered on-demand from large scale power plants, cloud computing is delivered from centralized data centers to users all over the world.

“DMZ” or Demilitarized Zone refers to a computer host or perimeter network inserted between a trusted internal network and an untrusted public network such as the Internet.

“FTP” or File Transfer Protocol is a protocol used to exchange or manipulate files over a computer network such as the Internet.

“MFT” or Managed File Transfer refers to software solutions that facilitate the secure transfer of data from one computer to another through a network.

“SaaS” or Software-as-a-Service uses hosted, cloud computing approaches in which the customer does not need to install the underlying software on its own computer systems to access the application.

**Part I. Financial Information****Item 1. Financial Statements**

**GlobalSCAPE, Inc.**  
**Condensed Consolidated Balance Sheets**  
(in thousands except share amounts)

	<b>June 30, 2018</b>	<b>December 31, 2017</b>
	<i>(Unaudited)</i>	
<b>Assets</b>		
Current assets:		
Cash and cash equivalents	\$ 11,914	\$ 11,583
Certificates of deposit, short term	4,311	4,291
Accounts receivable, net	4,246	5,925
Federal income tax receivable	979	822
Prepaid and other current assets	1,694	675
Total current assets	<u>23,144</u>	<u>23,296</u>
Certificates of deposit, long term	11,617	11,503
Capitalized software development costs, net	3,580	3,786
Goodwill	12,712	12,712
Deferred tax asset, net	379	651
Property and equipment, net	464	481
Other assets	616	84
Total assets	<u>\$ 52,512</u>	<u>\$ 52,513</u>
<b>Liabilities and Stockholders' Equity</b>		
Current liabilities:		
Accounts payable	\$ 2,192	\$ 1,900
Accrued expenses	1,571	1,671
Deferred revenue	13,022	13,315
Total current liabilities	<u>16,785</u>	<u>16,886</u>
Deferred revenue, non-current portion	2,991	3,735
Other long term liabilities	176	176
Commitments and contingencies		
Stockholders' equity:		
Preferred stock, par value \$0.001 per share, 10,000,000 authorized, no shares issued or outstanding	-	-
Common stock, par value \$0.001 per share, 40,000,000 authorized, 22,276,712 and 22,196,712 shares issued at June 30, 2018 and December 31, 2017, respectively	22	22
Additional paid-in capital	24,655	23,793
Treasury stock, 403,581 shares, at cost, at June 30, 2018 and December 31, 2017	(1,452)	(1,452)
Retained earnings	9,335	9,353
Total stockholders' equity	<u>32,560</u>	<u>31,716</u>
Total liabilities and stockholders' equity	<u>\$ 52,512</u>	<u>\$ 52,513</u>

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

**GlobalSCAPE, Inc.**  
**Condensed Consolidated Statements of Operations and Comprehensive Income (Loss)**  
(In thousands, except per share amounts)  
*(Unaudited)*

	<u>Three months ended June 30,</u>		<u>Six months ended June 30,</u>	
	<u>2018</u>	<u>2017</u>	<u>2018</u>	<u>2017</u>
Operating Revenues:				
Software licenses	\$ 2,722	\$ 2,700	\$ 4,882	\$ 5,279
Maintenance and support	5,285	5,222	10,385	10,343
Professional services	449	551	900	1,283
Total Revenues	<u>8,456</u>	<u>8,473</u>	<u>16,167</u>	<u>16,905</u>
Cost of revenues				
Software licenses	734	752	1,505	1,509
Maintenance and support	539	425	1,062	838
Professional services	292	353	616	717
Total cost of revenues	<u>1,565</u>	<u>1,530</u>	<u>3,183</u>	<u>3,064</u>
Gross profit	6,891	6,943	12,984	13,841
Operating expenses				
Sales and marketing	2,889	3,196	6,001	6,485
General and administrative	1,470	1,554	3,293	3,047
Legal and professional	1,046	335	2,725	556
Research and development	637	1,213	1,358	1,935
Total operating expenses	<u>6,042</u>	<u>6,298</u>	<u>13,377</u>	<u>12,023</u>
Income (loss) from operations	849	645	(393)	1,818
Interest income (expense), net	80	77	156	146
Income (loss) before income taxes	929	722	(237)	1,964
Income tax expense	336	265	105	676
Net income (loss)	<u>\$ 593</u>	<u>\$ 457</u>	<u>\$ (342)</u>	<u>\$ 1,288</u>
Comprehensive income (loss)	<u>\$ 593</u>	<u>\$ 457</u>	<u>\$ (342)</u>	<u>\$ 1,288</u>
Net income (loss) per common share -				
Basic	\$ 0.03	\$ 0.02	\$ (0.02)	\$ 0.06
Diluted	\$ 0.03	\$ 0.02	\$ (0.02)	\$ 0.06
Weighted average shares outstanding:				
Basic	21,838	21,675	21,816	21,610
Diluted	22,169	22,170	21,816	22,094
Cash dividends declared per share	\$ 0.015	\$ 0.015	\$ 0.030	\$ 0.030

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

**GlobalSCAPE, Inc.**  
**Condensed Consolidated Statements of Cash Flows**  
(in thousands)  
(Unaudited)

	<b>For the Six Months Ended June 30,</b>	
	<b>2018</b>	<b>2017</b>
Operating Activities:		
Net income (loss)	\$ (342)	\$ 1,288
Items not involving cash at the time they are recorded in the statement of operations:		
Provision (recoveries) for doubtful accounts receivable	(64)	11
Depreciation and amortization	1,120	1,056
Share-based compensation	862	671
Deferred taxes	12	(129)
Subtotal before changes in operating assets and liabilities	1,588	2,897
Changes in operating assets and liabilities:		
Accounts receivable	1,743	261
Prepaid and other current assets	(389)	106
Deferred revenue	(1,037)	(1,284)
Accounts payable	292	18
Accrued expenses	(100)	(138)
Other assets	77	143
Accrued interest receivable	(134)	(128)
Other long-term liabilities	-	19
Federal income tax receivable	(157)	(669)
Net cash provided by operating activities	1,883	1,225
Investing Activities:		
Software development costs capitalized	(793)	(938)
Purchase of property and equipment	(104)	(231)
Net cash (used in) investing activities	(897)	(1,169)
Financing Activities:		
Proceeds from exercise of stock options	-	458
Dividends paid	(655)	(652)
Net cash (used in) financing activities	(655)	(194)
Net increase (decrease) in cash	331	(138)
Cash at beginning of period	11,583	8,895
Cash at end of period	\$ 11,914	\$ 8,757
Supplemental disclosure of cash flow information:		
Cash paid during the period for:		
Interest	\$ -	\$ -
Income tax payments	\$ 213	\$ 1,504

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

**GlobalSCAPE, Inc.**  
**Condensed Consolidated Statement of Stockholders' Equity**  
(in thousands, except number of shares)  
(*unaudited*)

	<u>Common Stock</u>		<u>Additional Paid-in</u>	<u>Treasury</u>	<u>Retained</u>	
	<u>Shares</u>	<u>Amount</u>	<u>Capital</u>	<u>Stock</u>	<u>Earnings</u>	<u>Total</u>
Balance at December 31, 2017	22,196,712	\$ 22	\$ 23,793	\$ (1,452)	\$ 9,353	\$ 31,716
Retained Earnings Adjustment due to ASC 606					979	979
Stock-based compensation expense						
Stock options			742			742
Restricted stock	80,000		120			120
Common stock cash dividends					(655)	(655)
Net loss					(342)	(342)
Balance at June 30, 2018	<u>22,276,712</u>	<u>\$ 22</u>	<u>\$ 24,655</u>	<u>\$ (1,452)</u>	<u>\$ 9,335</u>	<u>\$ 32,560</u>

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

GlobalSCAPE, Inc.

Notes to Condensed Consolidated Financial Statements

As of June 30, 2018 and For the Three and Six

Months Then Ended

(Unaudited)

**1. Nature of Business**

GlobalSCAPE, Inc. and its wholly-owned subsidiary (together referred to as the “Company”, “GlobalSCAPE”, or “we”) provide secure information exchange capabilities for enterprises and consumers through the development and distribution of software, delivery of managed and hosted solutions, and provisioning of associated services. Our solution portfolio facilitates transmission of critical information such as financial data, medical records, customer files, vendor files, personnel files, transaction activity, and other similar documents between diverse and geographically separated network infrastructures while supporting a range of information protection approaches to meet privacy and other security requirements. In addition to enabling secure, flexible transmission of critical information using servers, desktop and notebook computers, and a wide range of network-enabled mobile devices, our products also provide customers with the ability to monitor and audit file transfer activities. Our primary product is Enhanced File Transfer, or EFT. We have other products that complement our EFT product.

In June 2017, we introduced a data integration product that we planned to sell under the brand name Kenetix. We licensed the technology for this product from a third party. This product is a cloud-based, integration-as-a-service, or iPaaS, solution used to connect applications, microservices, application program interfaces (or APIs), data and processes within and between organizations. We have experienced issues with the third-party technology and have determined to suspend marketing of the product as we evaluate options and determine whether the licensor can effectively address the issues.

We also sell other products that are synergistic to EFT including Mail Express, WAFS, and CuteFTP. Collectively, these products constitute less than 5% of our total revenue.

Throughout these notes unless otherwise noted, our references to the 2018 quarter and the 2017 quarter refer to the three months ended June 30, 2018 and 2017, respectively. Our references to the 2018 six months and the 2017 six months refer to the six months ended June 30, 2018 and 2017, respectively.

**2. Basis of Presentation**

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with Rule 10-01 of Regulation S-X, “Interim Financial Statements”, as prescribed by the United States Securities and Exchange Commission, or SEC. Accordingly, they do not include all information and footnotes required under United States generally accepted accounting principles, or GAAP, for complete financial statements. In the opinion of management, all accounting entries necessary for a fair presentation of our financial position and results of operations have been made. The results of operations for any interim period are not necessarily indicative of the results to be expected for the full year. The information included in this Form 10-Q should be read in conjunction with the consolidated financial statements and the notes thereto included in our Annual Report on Form 10-K for the fiscal year ended December 31, 2017, filed with the SEC on June 14, 2018, which we refer to as the 2017 Form 10-K, as well as *Management’s Discussion and Analysis of Financial Condition and Results of Operations* also included in our 2017 Form 10-K and in this report.

We follow accounting standards set by the Financial Accounting Standards Board or FASB. This board sets GAAP, which we follow in preparing financial statements that report our financial position, results of operations, and sources and uses of cash. We also follow the reporting regulations of the SEC.



The preparation of financial statements in accordance with GAAP requires the use of estimates and assumptions that affect the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities known to exist as of the date the financial statements are published, and the reported amounts of revenues and expenses during the reporting period. Uncertainties with respect to such estimates and assumptions are inherent in the preparation of our financial statements. It is possible the actual results could differ from these estimates and assumptions and could have a material effect on the reported amounts of our financial position and results of operations.

### 3. Significant Accounting Policies

#### *Principles of Consolidation*

The accompanying condensed consolidated financial statements are prepared in conformity with GAAP. All intercompany accounts and transactions have been eliminated.

#### *Reclassification of Expenses*

We have revised the classification of certain of our operating expenses. To ensure comparability between periods, we revised the previous period financial statements presented to conform to the method of presentation in the current period financial statements. These reclassifications had no impact on the net income (loss) for the periods presented or total stockholders' equity at June 30, 2018.

#### *Revenue Recognition*

##### Nature of Our Products and Services

We earn revenue by delivering the following software products and services:

- Perpetual software licenses under which customers install our products in their information systems environment on computers they manage and either own or otherwise procure from a cloud services provider, including deploying our products at a cloud services provider in a bring-your-own-license environment.
- Cloud-based, hosted SaaS solutions that we sell on an ongoing subscription basis resulting in our earning recurring, monthly subscription and usage fees to access the service.
- Maintenance and support services ("M&S") that generally consist of telephone support and access to unspecified future software upgrades.
- Professional services for product integration and configuration that generally do not significantly modify our software products.

We earn the majority of our revenue from the sale of perpetual software licenses and associated contracts for M&S.

We recognize revenue when we have satisfied a performance obligation by transferring control over a product or delivering a service to a customer. We measure revenue based upon the consideration set forth in an arrangement or contract with a customer. The revenue recognition criteria we apply to each of our software products and services are as follows:

- Perpetual software licenses – These licenses grant a right to use our functional intellectual property. We recognize revenue at the point in time when we electronically deliver to our customer the software license key that provides the ability to access and use our product. If our customer is a reseller who will further transfer the ability to access and use our product to a third party under a separate arrangement that the reseller has with that third party, we recognize revenue at the time we deliver the software license key to the reseller since our contract is with the reseller.
- Cloud-based, hosted SaaS solutions – These solutions grant a right to access our functional intellectual property. We recognize revenue over time on a monthly basis as we deliver the services to which our customers subscribe. This revenue can include basic monthly fees to access the software and usage fees based upon the volume of certain resources the customer consumes (such as volumes of storage or bandwidth). We are generally paid for these services on a month-to-month basis, but if a customer pays us in advance for services we will deliver in the future, we record as deferred revenue the amount of such payment related to services we have not yet delivered.

- M&S – We provide these services to purchasers of perpetual software licenses under agreements with terms generally ranging from one to three years. We require up-front payment of our M&S fee in an amount that covers the entire term of the agreement. We record as deferred revenue amounts paid that relate to future periods during which we will provide the M&S service. We reduce deferred revenue and recognize revenue ratably in future periods as we deliver the M&S service.
- Professional services – We recognize revenue from these services when the services are completed. If we are paid in advance for these services, we record such payment as deferred revenue until we complete the services.

The delivery of our software products and services generally does not involve any variable consideration, financing components or consideration payable to a customer such as rebates or other incentives that reduce amounts owed us by customers.

#### Deferred Revenue Classification and Activity

Deferred revenue related to services we will deliver within one year is presented as a current liability. Deferred revenue related to services that we will deliver more than one year into the future is presented as a non-current liability.

The activity in our deferred revenue balances has been as follows (\$in thousands):

	<u>Three Months Ended June 30,</u>		<u>Six Months Ended June 30,</u>	
	<u>2018</u>	<u>2017</u>	<u>2018</u>	<u>2017</u>
Deferred revenue, beginning of period	\$ 15,733	\$ 16,322	\$ 17,050	\$ 17,445
Deferred revenue resulting from new contracts with customers	5,659	5,228	9,557	9,445
Deferred revenue at the beginning of the period that was amortized to revenue	(4,827)	(4,897)	(9,614)	(9,816)
Deferred revenue arising during the period that was amortized to revenue	(552)	(493)	(980)	(914)
Deferred revenue, end of period	<u>\$ 16,013</u>	<u>\$ 16,160</u>	<u>\$ 16,013</u>	<u>\$ 16,160</u>

#### Multi-Element Transactions

At the time our customers purchase perpetual software licenses, they typically also purchase M&S although it is not mandatory that they do so to use the software. We do not sell separate M&S to subscribers to our SaaS solutions as M&S is provided as part of their SaaS subscription. Our customers may also purchase professional services at the time they purchase perpetual software licenses or a SaaS subscription. Each of the components of these multi-element transactions is a separately identifiable performance obligation.

For multi-element transactions, we allocate the transaction price to each performance obligation on a relative stand-alone selling price basis. We determine that stand-alone selling price for each item at the inception of the transaction involving these multiple elements.

We sell, as stand-alone transactions, renewals of pre-existing M&S contracts, professional services to customers seeking assistance with products they have previously purchased from us, or SaaS subscriptions to customers not requiring any of our other products or services. Accordingly, we are able to estimate the stand-alone selling price of these items based upon our observation of those transactions. Since most of our sales of perpetual software licenses are part of multi-element transactions that also involve M&S and/or professional services, and because the selling price of those licenses can vary significantly among customers, we use the residual approach under ASC 606 to estimate the selling price of perpetual software licenses in a multi-element transaction by reference to the total transaction price less the sum of the observable stand-alone selling prices of M&S and/or professional services.

We allocate discounts proportionally to all of the components of a multi-element transaction.

#### Sales Tax

We collect sales tax on many of our transactions with customers as required under applicable law. We do not include sales tax collected in our revenue. We record it as a liability payable to taxing authorities.

### Allowance for Sales Returns

We provide an allowance for sales returns. We estimate this allowance based upon our historical experience and the nature of recent transactions with customers. This amount is included in accrued liabilities in our condensed consolidated balance sheet.

### Contract Assets

We generally bill our customers for professional services when we have fully delivered the services specified in the contract with the customer. We may incur costs in delivering the services prior to that time. Such costs are generally not material. Accordingly, we do not record a contract asset for professional service engagements in process but not yet billed.

### Incremental Costs of Obtaining a Contract to Deliver Goods and Services

We incur incremental costs in the form of sales commissions paid to our sales personnel and royalties on certain of our products paid to third parties. These are costs that we would not incur if we did not obtain a contract to deliver our goods and services. We account for these costs as follows:

- If these costs are associated with products and services for which we recognize revenue at a fixed point in time (primarily sales of perpetual software licenses and professional services), we expense these costs in full at the time we recognize that revenue.
- If these costs are associated with services for which we recognize revenue over time (primarily sales of M&S and SaaS subscriptions) for which we believe it is likely that the contract for those services will be renewed for additional terms in the future, provided we deem these costs to be recoverable, we record these costs as a deferred expense asset and amortize that cost to expense as follows:
  - o For the portion of the cost that we determine benefits us primarily only over the term of the specific underlying contract currently in force (such as the term of an M&S contract), we recognize expense ratably each month over that term.
  - o For the portion of the cost that we determine benefits us over an overall customer relationship that is likely to span a period of time that is longer than an initial contract term (for example, an M&S contract renewed for multiple terms in the future), we recognize expense ratably monthly over the estimated life of the customer relationship.

Our activity in deferred costs of obtaining a contract to deliver goods and services has been as follows (\$in thousands):

	<b>Three Months Ended June 30, 2018</b>	<b>Six Months Ended June 30, 2018</b>
Deferred expense, beginning of period	\$ 1,184	\$ 1,240
Deferred expense resulting from new contracts with customers	198	347
Deferred expense amortized to expense	(210)	(415)
Deferred expense, end of period	<u>\$ 1,172</u>	<u>\$ 1,172</u>

At June 30, 2018, \$628,000 was recorded in prepaid and current other assets and \$544,000 was recorded in other assets in our condensed consolidated balance sheet.

The following tables present our reported results under FASB Accounting Standards Codification Topic 606, or ASC 606 and a reconciliation to results using the historical accounting method:

**Condensed Consolidated Balance Sheet**(in thousands)  
As of June 30, 2018  
(unaudited)

	<u>As Reported</u>	<u>Effect of ASC 606</u>	<u>ASC 605 Historical</u>
<b>Assets</b>			
Current assets:			
Cash and cash equivalents	\$ 11,914		\$ 11,914
Certificates of deposit, short term	4,311		4,311
Accounts receivable, net	4,246	(100)	4,146
Federal income tax receivable	979	16	995
Prepaid and other current assets	1,694	(625)	1,069
Total current assets	<u>23,144</u>	<u>(709)</u>	<u>22,435</u>
Certificates of deposit, long term	11,617		11,617
Capitalized software development costs, net	3,580		3,580
Goodwill	12,712		12,712
Deferred tax asset, net	379	249	628
Property and equipment, net	464		464
Other assets	616	(544)	72
Total assets	<u>\$ 52,512</u>	<u>\$ (1,004)</u>	<u>\$ 51,508</u>
<b>Liabilities and Stockholders' Equity</b>			
Current liabilities:			
Accounts payable	2,192		2,192
Accrued expenses	1,571	(100)	1,471
Deferred revenue	13,022		13,022
Total current liabilities	<u>16,785</u>	<u>(100)</u>	<u>16,685</u>
Deferred revenue, non-current portion	2,991		2,991
Other long term liabilities	176		176
Stockholders' Equity:			
Preferred stock	-		-
Common stock	22		22
Additional paid-in capital	24,655		24,655
Treasury stock	(1,452)		(1,452)
Retained earnings	9,335	(904)	8,431
Total stockholders' equity	<u>32,560</u>	<u>(904)</u>	<u>31,656</u>
Total liabilities and stockholders' equity	<u>\$ 52,512</u>	<u>\$ (1,004)</u>	<u>\$ 51,508</u>

**Condensed Consolidated Statement of Operations and Comprehensive Income**

(in thousands, except per share amounts)  
For the Three Months Ended June 30, 2018  
(unaudited)

	<u>As Reported</u>	<u>Effect of ASC 606</u>	<u>ASC 605 Historical</u>
Operating revenues:			
Software licenses	\$ 2,722		\$ 2,722
Maintenance and support	5,285		5,285
Professional services	449		449
Total revenues	<u>8,456</u>	<u>-</u>	<u>8,456</u>
Costs of revenues			
Software licenses	734	11	745
Maintenance and support	539		539
Professional services	292		292
Total costs of revenues	<u>1,565</u>	<u>11</u>	<u>1,576</u>
Gross Profit	<u>6,891</u>	<u>(11)</u>	<u>6,880</u>
Operating expenses			
Sales and marketing	2,889	(23)	2,866
General and administrative	1,470		1,470
Legal and professional	1,046		1,046
Research and development	637		637
Total operating expenses	<u>6,042</u>	<u>(23)</u>	<u>6,019</u>
Income (loss) from operations	849	12	861
Interest income (expense), net	80		80
Income (loss) before income taxes	<u>929</u>	<u>12</u>	<u>941</u>
Income tax expense	336	4	340
Net income	<u>\$ 593</u>	<u>\$ 8</u>	<u>\$ 601</u>
Comprehensive income	<u>\$ 593</u>	<u>\$ 8</u>	<u>\$ 601</u>
Net income per common share - basic	<u>\$ 0.03</u>	<u>\$ 0.00</u>	<u>\$ 0.03</u>
Net income per common share - diluted	<u>\$ 0.03</u>	<u>\$ 0.00</u>	<u>\$ 0.03</u>

**Condensed Consolidated Statement of Operations and Comprehensive Income (Loss)**

(in thousands, except per share amounts)

For the Six Months Ended June 30, 2018

(unaudited)

	<u>As Reported</u>	<u>Effect of ASC 606</u>	<u>ASC 605 Historical</u>
Operating revenues:			
Software licenses	\$ 4,882		\$ 4,882
Maintenance and support	10,385		10,385
Professional services	900		900
Total revenues	<u>16,167</u>	<u>-</u>	<u>16,167</u>
Costs of revenues			
Software licenses	1,505	(14)	1,491
Maintenance and support	1,062		1,062
Professional services	616		616
Total costs of revenues	<u>3,183</u>	<u>(14)</u>	<u>3,169</u>
Gross Profit	<u>12,984</u>	<u>14</u>	<u>12,998</u>
Operating expenses			
Sales and marketing	6,001	(54)	5,947
General and administrative	3,293		3,293
Legal and professional	2,725		2,725
Research and development	1,358		1,358
Total operating expenses	<u>13,377</u>	<u>(54)</u>	<u>13,323</u>
Income (loss) from operations	<u>(393)</u>	<u>68</u>	<u>(325)</u>
Interest income (expense), net	156		156
Income (loss) before income taxes	<u>(237)</u>	<u>68</u>	<u>(169)</u>
Income tax expense	105	16	121
Net income (loss)	<u>\$ (342)</u>	<u>\$ 52</u>	<u>\$ (290)</u>
Comprehensive income (loss)	<u>\$ (342)</u>	<u>\$ 52</u>	<u>\$ (290)</u>
Net income (loss) per common share - basic	<u>\$ (0.02)</u>	<u>\$ 0.00</u>	<u>\$ (0.01)</u>
Net income (loss) per common share - diluted	<u>\$ (0.02)</u>	<u>\$ 0.00</u>	<u>\$ (0.01)</u>

**Condensed Consolidated Statements of Cash Flows**  
(in thousands)  
For the Six Months Ended June 30, 2018  
(*unaudited*)

	<u>As Reported</u>	<u>Effect of ASC 606</u>	<u>ASC 605 Historical</u>
Operating Activities:			
Net loss	\$ (342)	52	\$ (290)
Items not involving cash at the time they are recorded in the statement of operations:			
Provision (recoveries) for doubtful accounts receivable	(64)		(64)
Depreciation and amortization	1,120		1,120
Share-based compensation	862		862
Deferred taxes	12		12
Subtotal before changes in operating assets and liabilities	<u>1,588</u>	<u>52</u>	<u>1,640</u>
Changes in operating assets and liabilities:			
Accounts receivable	1,743	(100)	1,643
Prepaid and other current assets	(389)	(68)	(457)
Deferred revenues	(1,037)		(1,037)
Accounts payable	292		292
Accrued expenses	(100)	100	-
Other assets	77		77
Accrued interest receivable	(134)		(134)
Federal income tax receivable	(157)	16	(141)
Net cash provided by operating activities	<u>1,883</u>	<u>-</u>	<u>1,883</u>
Investing Activities:			
Software development costs	(793)		(793)
Purchase of property and equipment	(104)		(104)
Net cash (used in) investing activities	<u>(897)</u>	<u>-</u>	<u>(897)</u>
Financing Activities:			
Proceeds from exercise of stock options	-		-
Dividends paid	(655)		(655)
Net cash (used in) financing activities	<u>(655)</u>	<u>-</u>	<u>(655)</u>
Net increase in cash	331		331
Cash at beginning of period	11,583	-	11,583
Cash at end of period	<u>\$ 11,914</u>	<u>\$ -</u>	<u>\$ 11,914</u>
Supplemental disclosure of cash flow information:			
Cash paid during the period for:			
Interest	<u>\$ -</u>		<u>\$ -</u>
Income tax payments	<u>\$ 213</u>		<u>\$ 213</u>

### ***Cash and cash equivalents***

Cash and cash equivalents includes all cash and highly liquid investments with original maturities of three months or less.

### ***Property and Equipment***

Property and equipment is comprised of furniture and fixtures, software, computer equipment and leasehold improvements which are recorded at cost and depreciated using the straight-line method over their estimated useful lives. Furniture, fixtures and equipment have a useful life of five to seven years, computer equipment and software have a useful life of three years and leasehold improvements have a useful life that is the shorter of the term of the lease under which the improvements were made or the estimated useful life of the asset.

Expenditures for maintenance and repairs are expensed as incurred.

### ***Goodwill***

Goodwill is not amortized. On at least an annual basis, we test goodwill for impairment at the reporting unit level using December 31 as the measurement date. We operate as a single reporting unit.

When testing goodwill, we first assess qualitative factors to determine whether it is more likely than not (that is, a likelihood of more than 50 percent) that the fair value of our reporting unit is less than its carrying amount, including goodwill. In performing this qualitative assessment, we assess events and circumstances relevant to us including, but not limited to:

- Macroeconomic conditions.
- Industry and market considerations.
- Cost factors and trends for labor and other expenses of operating our business.
- Our overall financial performance and outlook for the future.
- Trends in the quoted market value and trading of our common stock.

In considering these and other factors, we consider the extent to which any adverse events and circumstances identified could affect the comparison of our reporting unit's fair value with its carrying amount. We place more weight on events and circumstances that most affect our reporting unit's fair value or the carrying amount of our net assets. We consider positive and mitigating events and circumstances that may affect our determination of whether it is more likely than not that the fair value of our reporting unit is less than its carrying amount. We evaluate, on the basis of the weight of the evidence, the significance of all identified events and circumstances in the context of determining whether it is more likely than not that the fair value of our reporting unit is less than its carrying amount.

If, after assessing the totality of these qualitative events and circumstances, we determine it is not more likely than not that the fair value of our reporting unit is less than its carrying amount, we conclude there is no impairment of goodwill and perform no further testing, in accordance with GAAP. If we conclude otherwise, we proceed with performing the first step, and if necessary, the second step, of the two-step goodwill impairment test prescribed by GAAP.

As of December 31, 2017, after assessing the totality of the relevant events and circumstances, we determined it not more likely than not that the fair value of our reporting unit was less than its carrying amount. Accordingly, we concluded there was no impairment of goodwill as of that date. There have been no material events or changes in circumstances since that time indicating that the carrying amount of goodwill may exceed its fair market value and that interim testing needed to be performed.

### ***Capitalized Software Development Costs***

When we complete research and development for a software product and have in place a program plan and a detailed program design or a working model of that software product, we capitalize production costs incurred for that software product from that point forward until it is ready for general release to the public. Thereafter, we amortize capitalized software production costs to expense using the straight-line method over the estimated useful life of that product, which is generally three years. We periodically assess the carrying value of capitalized software development costs and our method of amortizing them relative to our estimates of realizability through sales of products in the marketplace.



### ***Research and Development***

We expense research and development costs as incurred.

### ***Advertising Expense***

We expense advertising costs as incurred as a component of our sales and marketing expenses. Advertising expense was approximately \$254,000 and \$608,000 in the 2018 quarter and the 2017 quarter, respectively, and \$577,000 and \$1,028,000 in the 2018 six months and 2017 six months, respectively.

### ***Share-Based Compensation***

We measure the cost of share-based payment transactions at the grant date based on the calculated fair value of the award. We recognize this cost as an expense ratably over the recipient's requisite service period during which that award vests or becomes unrestricted.

For stock option awards, we estimate their fair value at the grant date using the Black-Scholes option-pricing model considering the following factors:

- We estimate expected volatility based on historical volatility of our common stock.
- We use primarily the simplified method to derive an expected term which represents an estimate of the time options are expected to remain outstanding. We use this method because our options are plain-vanilla options, and we believe our historical option exercise experience is not adequately indicative of our future expectations.
- We base the risk-free rate for periods within the contractual life of the option on the U.S. treasury yield curve in effect at the time of grant.
- We estimate a dividend yield based on our historical and expected future dividend payments.

For restricted stock awards, we use the quoted price of our common stock on the grant date as the fair value of the award.

### ***Income Taxes***

We account for income taxes using the asset and liability method. We record deferred tax assets and liabilities based on the difference between the tax bases of assets and liabilities and their carrying amount for financial reporting purposes, as measured by the enacted tax rates and laws that will be in effect when the differences are expected to reverse. Deferred tax assets and liabilities are carried on the balance sheet with the presumption that they will be realizable in future periods in which we generate taxable income.

We assess the likelihood that deferred tax assets will be realized from future taxable income. Based on this assessment, we provide any necessary valuation allowance on our balance sheet with a corresponding increase in the tax provision on our statement of operations. Any valuation allowances we establish are determined based upon a number of assumptions, judgments, and estimates, including forecasted earnings, future taxable income, and the relative proportions of revenue and income before taxes in the various domestic jurisdictions in which we operate.

We account for uncertainty in income taxes using a two-step process to determine the amount of tax benefit to be recognized. First, we evaluate the tax position to determine the likelihood that it will be sustained upon external examination. If the tax position is deemed "more-likely-than-not" to be sustained, we assess the tax position to determine the amount of benefit to recognize in the consolidated financial statements. The amount of the benefit we recognize is the largest amount that we believe has a greater than 50 percent likelihood of being realized upon ultimate settlement. Unrecognized tax benefits represent tax positions for which reserves have been established.

### ***Earnings Per Share***

We compute basic earnings per share using the weighted-average number of common shares outstanding during the periods. We compute diluted earnings per share using the weighted-average number of common shares outstanding plus the number of common shares that would be issued assuming conversion of all potentially dilutive common shares outstanding.

Awards of non-vested restricted stock and options are considered potentially dilutive common shares for the purpose of computing earnings per common share. We apply the treasury stock method to non-vested options under which the assumed proceeds include the amount the employee must pay to exercise the option plus the amount of unrecognized cost attributable to future periods less any expected tax benefits.

### ***Recent accounting pronouncements***

The Financial Accounting Standards Board, or FASB, has issued the Accounting Standard Updates (ASU) described below that we believe may be relevant to our business and to the preparation of our financial statements.

*ASU 2017-09, Compensation—Stock Compensation (Topic 718): Scope of Modification Accounting (issued September 2017)* – This update provides guidance about which changes to the terms or conditions of a share-based payment award require an entity to apply modification accounting. It states that in these situations, modification accounting should be applied unless the fair value of the modified award is the same as the fair value of the original award immediately before the original award was modified, the vesting conditions of the modified award are the same as the vesting conditions of the original award immediately before the original award was modified, and the classification of the modified award as equity or a liability is the same as the classification of the original award immediately before the original award was modified. This update is effective for all entities for annual periods, and interim periods within those annual periods, beginning after December 15, 2017. We adopted this pronouncement in the first quarter of 2018 and do not expect this pronouncement to have a material effect on how we account for the changes to the terms or conditions of a share-based payment award.

*ASU 2017-04, Intangibles – Goodwill and Other (issued January 2017)* - To simplify the subsequent measurement of goodwill, Step 2 was eliminated from the goodwill impairment test. In computing the implied fair value of goodwill under Step 2, an entity had to perform procedures to determine the fair value at the impairment testing date of its assets and liabilities (including unrecognized assets and liabilities) following the procedure that would be required in determining the fair value of assets acquired and liabilities assumed in a business combination. Instead, under the amendments in this update, an entity should perform its annual, or interim, goodwill impairment test by comparing the fair value of a reporting unit with its carrying amount. An entity should recognize an impairment charge for the amount by which the carrying amount exceeds the reporting unit's fair value. Any loss recognized should not exceed the total amount of goodwill allocated to that reporting unit. Additionally, an entity should consider income tax effects from any tax deductible goodwill on the carrying amount of the reporting unit when measuring the goodwill impairment loss, if applicable. This update also eliminated the requirements for any reporting unit with a zero or negative carrying amount to perform a qualitative assessment and, if it fails that qualitative test, to perform Step 2 of the goodwill impairment test. Therefore, the same impairment assessment applies to all reporting units. An entity is required to disclose the amount of goodwill allocated to each reporting unit with a zero or negative carrying amount of net assets. An entity still has the option to perform the qualitative assessment for a reporting unit to determine if the quantitative impairment test is necessary. A public business entity that is a U.S. Securities and Exchange Commission ("SEC") filer is required to adopt the amendments in this update for its annual or any interim goodwill impairment tests in fiscal years beginning after December 15, 2019. We expect that the application of the provisions of this update will not have a material effect on our consolidated financial statements.

*ASU 2016-15, Statement of Cash Flows – Classification of Certain Cash Receipts and Cash Payments (issued June 2016)* - This pronouncement provides guidance as to the treatment of transactions in a statement of cash flows with respect to eight specific cash flow issues. During 2017 and the first six months of 2018, we had no transactions of the type cited in the statement and do not anticipate having any such transactions in the foreseeable future. Accordingly, we do not expect this pronouncement to have a material effect on how we present items in our consolidated statement of cash flows.

*ASU 2016-13, Financial Instruments – Credit Losses (issued June 2016)* - Among the provisions of this ASU is a requirement that assets measured at amortized cost, which includes trade accounts receivable, be presented at the net amount expected to be collected. This pronouncement requires that an entity reflect all of its expected credit losses based on current estimates which will replace the current standard requiring that an entity need consider only past events and current conditions in measuring an incurred loss. We are subject to this guidance effective with consolidated financial statements we issue for the year ending December 31, 2020, and the quarterly periods during that year. We do not expect the amounts we report as accounts receivable in those future periods under this guidance to be materially affected relative to current guidance.

*ASU 2016-02, Leases (issued February 2016)* - The main difference between existing GAAP and this ASU 2016-02 is the presentation by lessees on their financial statements of lease assets and lease liabilities arising from operating leases. Since this new standard retains the distinction between finance and operating leases, the effect of leases in the statement of operations and the statement of cash flows will be largely unchanged from existing GAAP. Our only lease of significance is our operating lease for our corporate office space for which we will present a right-to-use asset and a lease liability on our consolidated balance sheet when we implement this standard. We are in the process of determining those amounts. In accordance with this standard, we will implement it beginning with our interim and annual consolidated financial statements for 2019. The extent of the effect of this standard on our consolidated financial statements for 2019 and later will depend upon the leases, if any, that we have in effect at that date.

*ASU 2014-09, Revenue from Contracts with Customers (issued May 2014)* - The core principle of this guidance is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects consideration to which the entity expects to be entitled in exchange for those goods or services. We have implemented these new principles using the modified retrospective transition method and recorded an increase (tax effected) to retained earnings at January 1, 2018 of \$979,000. We also recorded as an asset deferred expense of approximately \$1.2 million. We are accounting for these costs we incur to obtain a contract as follows:

- If these costs are associated with products and services for which we recognize revenue at a point in time (primarily sales of perpetual software licenses and professional services), we expense these costs in full at the time we recognize that revenue.
- If these costs are associated with services for which we recognize revenue over time (primarily sales of M&S and SaaS subscriptions) for which we believe it is likely that the contract for those services will be renewed for additional terms in the future, provided we deem these costs to be recoverable, we record these costs as deferred expense asset and amortize that cost to expense as follows:
  - For the portion of the cost that we determine benefits us primarily only over the term of the specific underlying contract currently in force (such as the term of an M&S contract), we will recognize expense ratably each month over that term.
  - For the portion of the cost that we determine benefits us over an overall customer relationship that is likely to span a period of time that is longer than an initial contract term (for example, an M&S contract renewed for multiple terms in the future), we will recognize expense ratably monthly over the estimated life of the customer relationship.

#### **4. Certificates of Deposit**

Our certificates of deposit are held at a bank and mature at various dates through December 2021. Certificates of deposit with contractual maturity dates less than one year from the balance sheet date are presented as current assets. Certificates of deposit with contractual maturity dates beyond one year from the balance sheet date are presented as non-current assets.

We have the ability to hold these certificates of deposit until their maturity dates and as of the date of this report intend to do so. We measure these investments on a recurring basis using Level 1 of the fair value hierarchy prescribed by GAAP which results in them being presented at original cost plus accrued interest earned. There is no amortization of original cost associated with our certificates of deposit.

## 5. Accounts Receivable, Net

We bill our customers and issue them an invoice when we have delivered our goods or services to them. In addition, when our customers agree to purchase or renew M&S services, we bill and invoice our customers at that time which could be before the date we begin delivering those services. In that event, we exclude from accounts receivable (and from the related deferred revenue, see Note 3) the invoices we have issued for which the M&S services commencement date is in the future and which have not been paid by the customer as of the date of our consolidated financial statements. We continually assess the collectability of our accounts receivable. If we deem it less than probable that we will collect an amount due us, we write-off that balance against our allowance for doubtful accounts. Accordingly, we determine our accounts receivable, net, as follows ( \$in thousands):

	<b>June 30, 2018</b>	<b>December 31, 2017</b>
Total invoices issued and unpaid	\$ 5,001	\$ 6,644
Less: Unpaid invoices relating to M&S contracts with a start date subsequent to the balance sheet date	(655)	(441)
Gross accounts receivable	4,346	6,203
Allowance for doubtful accounts	(100)	(278)
Accounts receivable, net	<u>\$ 4,246</u>	<u>\$ 5,925</u>

## 6. Capitalized Software Development Costs, Net

Our capitalized software development costs balances and activities were as follows ( \$in thousands):

	<b>June 30, 2018</b>	<b>December 31, 2017</b>
Gross capitalized cost	\$ 9,971	\$ 9,179
Accumulated amortization	(6,391)	(5,393)
Capitalized software development costs, net	<u>\$ 3,580</u>	<u>\$ 3,786</u>

	<b>Three Months Ended June 30,</b>		<b>Six Months Ended June 30,</b>	
	<b>2018</b>	<b>2017</b>	<b>2018</b>	<b>2017</b>
Amount capitalized	\$ 390	\$ 476	\$ 793	\$ 938
Amortization expense	(464)	(446)	(999)	(920)

	<b>Released Products</b>	<b>Unreleased Products</b>
Gross capitalized amount at June 30, 2018	\$ 9,388	\$ 583
Accumulated amortization	(6,391)	-
Net capitalized cost at June 30, 2018	<u>\$ 2,997</u>	<u>\$ 583</u>

Future amortization expense:	
Six months ending December 31, 2018	854
Year ending December 31,	
2019	1,288
2020	778
2021	77
Total	<u>\$ 2,997</u>

The future amortization expense of the gross capitalized software development costs related to unreleased products will be determinable at a future date when those products are ready for general release to the public.

## 7. Deferred Revenue

As described in Note 5 regarding accounts receivable, when our customers agree to purchase or renew M&S services, we bill and invoice our customers at that time which could be before the date we begin delivering those services. In that event, we exclude from deferred revenue (and from the related accounts receivable) the invoices we have issued for which the M&S services commencement date is in the future and which have not been paid by the customer as of the date of our financial statements. Accordingly, we determine our deferred revenue as follows ( \$in thousands):

	<b>June 30, 2018</b>	<b>December 31, 2017</b>
Total invoiced for M&S contracts for which revenue will be recognized in future periods	\$ 16,668	\$ 17,491
Less: Unpaid invoices relating to M&S contracts with a start date subsequent to the balance sheet date	(655)	(441)
<b>Total deferred revenue</b>	<b>\$ 16,013</b>	<b>\$ 17,050</b>
Deferred revenue, current portion	\$ 13,022	\$ 13,315
Deferred revenue, non-current portion	2,991	3,735
<b>Total deferred revenue</b>	<b>\$ 16,013</b>	<b>\$ 17,050</b>

## 8. Stock Options, Restricted Stock and Share-Based Compensation

We have stock-based compensation plans under which we have granted, and may grant in the future, incentive stock options, non-qualified stock options, and restricted stock to employees and non-employee members of the Board of Directors. Our share-based compensation expense was as follows ( \$in thousands):

	<b>Three Months Ended June 30,</b>		<b>Six Months Ended June 30,</b>	
	<b>2018</b>	<b>2017</b>	<b>2018</b>	<b>2017</b>
Share-based compensation expense	\$ 191	\$ 335	\$ 862	\$ 671

### *Stock Options*

We have granted stock options to our officers and employees under long-term equity incentive plans that originated in 2000, 2010 and 2016. During the 2018 quarter, we granted stock options only under the 2016 plan.

Provisions and characteristics of the options granted to our officers and employees under our long-term equity incentive plans include the following:

- The exercise price, term and other conditions applicable to each stock option or stock award granted are determined by the Compensation Committee of the Board of Directors.
- The exercise price of stock options is set on the grant date and may not be less than the fair market value per share of our stock at market close on that date.
- Stock options we issue generally become exercisable ratably over a three-year period, expire ten years from the date of grant, and are exercisable for a period of ninety days after the end of employment.
- Upon exercise of a stock option, we issue new shares from the shares of common stock we are authorized to issue.

We currently issue stock-based awards to our officers and employees only under the 2016 plan which authorizes the issuance of up to 5,000,000 shares of common stock for stock-based incentives including stock options and restricted stock awards. As of June 30, 2018, stock-based incentives for up to 4,219,616 shares remained available for issuance in the future under this plan.

We have not previously issued any restricted stock under any of these plans.

Our stock option activity has been as follows:

	Number of Shares	Weighted Average Exercise Price Per Share	Weighted Average Remaining Contractual Term in Years	Aggregate Intrinsic Value (000's)
Outstanding at December 31, 2017	2,585,210	\$ 3.34	6.77	\$ 1,015
Granted	110,737	\$ 3.61		
Forfeited	(447,155)	\$ 3.56		
Exercised	-	-		
Outstanding at June 30, 2018	<u>2,248,792</u>	\$ 3.30	6.29	\$ 1,431
Exercisable at June 30, 2018	<u>1,357,682</u>	\$ 2.94	4.74	\$ 1,266

Additional information about our stock options is as follows:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2018	2017	2018	2017
Weighted average fair value of options granted	\$ 1.60	\$ 1.87	\$ 1.55	\$ 1.61
Intrinsic value of options exercised	\$ -	\$ 242,223	\$ -	\$ 342,609
Cash received from stock options exercised	\$ -	\$ 368,235	\$ -	\$ 458,349
Number of options that vested	78,327	107,030	439,152	402,154
Fair value of options that vested	\$ 129,731	\$ 173,857	\$ 707,951	\$ 653,600
Unrecognized compensation expense related to non-vested options at end of period	\$ 1,127,715	\$ 2,210,862	\$ 1,127,715	\$ 2,210,862
Weighted average years over which non-vested option expense will be recognized	1.73	2.17	1.73	2.17

Plan	Shares outstanding
2000 Stock Option Plan	84,770
2010 Employee LT Equity Incentive Plan	1,383,638
2016 Employee LT Equity Incentive Plan	780,384
Total shares outstanding at June 30, 2018	<u>2,248,792</u>

As of June 30, 2018					
Range of Exercise Prices	Underlying Shares Outstanding	Options Outstanding		Options Exercisable	
		Weighted Average Remaining Contractual Life	Weighted Average Exercise Price	Number of Underlying Shares	Weighted Average Exercise Price
\$0.85 - \$1.43	50,700	1.74	\$ 1.02	50,700	\$ 1.02
\$1.47 - \$2.32	335,070	2.43	\$ 1.85	335,070	\$ 1.85
\$2.34 - \$3.52	767,637	5.33	\$ 3.29	618,859	\$ 3.26
\$3.53 - \$5.30	1,090,385	8.33	\$ 3.86	353,053	\$ 3.70
\$5.44 - \$5.44	5,000	9.05	\$ 5.44	-	-
Total options	<u>2,248,792</u>			<u>1,357,682</u>	

We used the following assumptions to determine compensation expense for our stock options using the Black-Scholes option-pricing model:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2018	2017	2018	2017
Expected volatility	48%	51%	49%	49%
Expected annual dividend yield	1.50%	1.50%	1.50%	1.50%
Risk free rate of return	2.77%	1.93%	2.57%	1.94%
Expected option term (years)	6.00	6.00	6.00	6.00

#### Restricted Stock Awards

Our 2015 Non-Employee Directors Long-Term Equity Incentive Plan (“2015 Directors Plan”) provides for the issuance of either stock options or restricted stock awards for up to 500,000 shares of our common stock. Provisions and characteristics of this plan include the following:

- The exercise price, term and other conditions applicable to each stock option or stock award granted are determined by the Compensation Committee of the Board of Directors.
- Restricted stock awards are initially issued as restricted shares with a legend restricting transferability of the shares until the recipient satisfies the vesting provision of the award, which is generally continuing service for one year subsequent to the date of the award, after which time the restrictive legend is removed from the shares.
- Restricted shares participate in dividend payments and may be voted.
- As of June 30, 2018, stock based incentives for up to 260,000 shares remained available for issuance in the future under this plan.

Our restricted stock awards activity has been as follows:

	Number of Shares	Grant Date Fair Value Per Share	Total Fair Value of Shares That Vested
Restricted shares outstanding at December 31, 2017	80,000	\$ 4.24	
Shares granted with restrictions	-	\$ -	
Shares vested and restrictions removed	(80,000)	\$ 4.24	\$ 297,600
Restricted shares outstanding at June 30, 2018	-	\$ -	
Unrecognized compensation expense for non-vested shares as of June 30, 2018			
Expense to be recognized in future periods	\$ -		
Weighted average number of months over which expense is expected to be recognized	-		

## 9. Income Taxes

The components of our income tax expense (benefit) are as follows ( \$in thousands):

	Three months ended June 30,						Six months ended June 30,					
	2018			2017			2018			2017		
	Current	Deferred	Total	Current	Deferred	Total	Current	Deferred	Total	Current	Deferred	Total
Federal	\$ 37	\$ 266	\$ 303	\$ 317	\$ (94)	\$ 223	\$ 78	\$ 7	\$ 85	\$ 707	\$ (116)	\$ 591
State	39	(6)	33	55	(13)	42	15	5	20	98	(13)	85
Total	\$ 76	\$ 260	\$ 336	\$ 372	\$ (107)	\$ 265	\$ 93	\$ 12	\$ 105	\$ 805	\$ (129)	\$ 676

Deferred income taxes on our consolidated balance sheet 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.

Significant components of our deferred tax assets and liabilities are as follows ( \$in thousands):

	<b>June 30,</b>	<b>December 31,</b>
	<b>2018</b>	<b>2017</b>
Deferred tax assets:		
Deferred revenue	\$ 834	\$ 775
Share-based compensation	319	351
Compensation and benefits	115	111
Texas franchise tax R&D credit	189	185
Prepaid expenses not deductible for tax	-	84
Allowance for doubtful accounts	42	58
Net operating loss carryforward	10	20
Deferred state income taxes	56	61
Federal R&D credits	-	-
Accrued expenses not deducted for tax	11	9
Valuation allowance	(189)	(185)
Total deferred tax assets	<u>1,387</u>	<u>1,469</u>
Deferred tax liabilities:		
Intangible assets	762	805
Book expenses deductible for tax purposes	246	-
Depreciation	-	13
Total gross deferred tax liabilities	<u>1,008</u>	<u>818</u>
Net deferred tax assets	<u>\$ 379</u>	<u>\$ 651</u>

In assessing the realizability of deferred tax assets, we consider whether it is more-likely-than-not that some portion or all the deferred tax asset will not be realized. The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income during the periods in which those temporary differences become deductible. We have concluded it is more-likely-than-not that our ability to generate future taxable income will allow us to realize those deferred tax assets.

As of June 30, 2018, we had federal income tax net operating loss carryforwards of \$47,000 available to offset future federal taxable income. We expect to fully utilize this net operating loss in 2018. The net operating loss expires in 2038.

As of June 30, 2018, we had Texas Research and Development tax credit carryforwards of \$189,000. We believe it is uncertain that we will have sufficient Texas Franchise Tax in the future to support utilization of these carryforward credits. Accordingly, have provided a valuation allowance for the full amount of these credit carryforwards.

These carryforwards expire in years 2034 through 2038.

The aggregate changes in the balance of our gross unrecognized tax benefits were as follows ( \$in thousands):

	<b>Six Months Ended June 30,</b>	
	<b>2018</b>	<b>2017</b>
Balance at beginning of period	\$ 158	\$ 121
Increases for tax positions related to the current year	7	11
Increases for tax positions related to prior years	-	15
Balance at end of period	<u>\$ 165</u>	<u>\$ 147</u>



Our unrecognized tax benefit is related to research and development credits taken on our U.S. income tax returns from 2011 to 2017 and the uncertainty related to the realization of a portion of those credits based on prior experience. We believe it reasonably possible that we will not recognize any of our unrecognized tax benefits at least through December 31, 2018. If we realized and recognized any of our unrecognized tax benefits, such benefits would reduce our effective tax rate in the year of recognition.

We record interest and penalty expense related to income taxes as interest and other expense, respectively. At June 30, 2018, no interest or penalties had been or are required to be accrued. Our open tax years are 2011 and forward for our federal income tax returns and 2013 and forward for most of our state income tax returns. We do not file, and are not required to file, any foreign income tax returns.

Our income tax expense (benefit) reconciles to an income tax expense resulting from applying an assumed statutory federal income rate of 21% for the 2018 quarter and 2018 six months and 34% for the 2017 quarter and 2017 six months to income before income taxes as follows ( \$ in thousands):

	Three months ended June 30,		Six months ended June 30,	
	2018	2017	2018	2017
Income tax expense (benefit) at federal statutory rate	\$ 195	\$ 245	\$ (50)	\$ 668
Increase (decrease) in taxes resulting from:				
State taxes, net of federal benefit	25	23	30	51
Stock based compensation	121	24	151	84
Other	10	6	5	13
R&D tax credit uncertain tax position (net)	4	6	7	26
Research and development credit	(19)	(31)	(38)	(147)
Domestic production activities deduction	-	(8)	-	(19)
Income tax expense per the statements of operations	\$ 336	\$ 265	\$ 105	\$ 676

On June 21, 2018, in *South Dakota v Wayfair Inc.*, the United States Supreme Court held that states may charge sales tax on purchases made from out-of-state sellers, even if the seller does not have a physical presence in the taxing state.

We are evaluating our state income tax filings with respect to the recent Wayfair decision.

Currently, we file state income tax returns in those states in which we have a physical presence and/or are otherwise required by a state to register to do business.

## 10. Earnings (Loss) per Common Share

Earnings (loss) per share for the periods indicated were as follows (in thousands, except per share amounts):

	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
	2018	2017	2018	2017
<b>Numerators</b>				
Numerator for basic and diluted earnings per share:				
Net income (loss)	\$ 593	\$ 457	\$ (342)	\$ 1,288
<b>Denominators</b>				
Denominators for basic and diluted earnings (loss) per share:				
Weighted average shares outstanding - basic	21,838	21,675	21,816	21,610
<b>Dilutive potential common shares</b>				
Stock options and awards	331	495	-	484
Denominator for diluted earnings (loss) per share	22,169	22,170	21,816	22,094
Net income (loss) per common share - basic	\$ 0.03	\$ 0.02	\$ (0.02)	\$ 0.06
Net income (loss) per common share – diluted	\$ 0.03	\$ 0.02	\$ (0.02)	\$ 0.06

Due to the loss for the six months ended June 30, 2018, potentially dilutive securities related to stock options and awards of 323,000 have not been included in the dilutive earnings (loss) computation above as they are antidilutive.

As a result of our implementation of *ASU 2016-09, Improvements to Employee Share-Based Payment Accounting (issued March 2016)*, the estimated proceeds resulting from equity compensation deductible for federal income tax purposes being greater than the associated share-based compensation expense are no longer considered as part of the treasury stock method used in computing diluted earnings per share. This change had no material effect on our earnings per share computations.

## 11. Dividends

We paid dividends during the 2018 six months and 2017 six months as follows:

	Three Months Ended			
	March 31, 2018	March 31, 2017	June 30, 2018	June 30, 2017
Dividend per share of common stock	\$ 0.015	\$ 0.015	\$ 0.015	\$ 0.015
Dividend record date	March 9, 2018	February 23, 2017	June 8, 2018	May 23, 2017
Dividend payment date	March 23, 2018	March 8, 2017	June 22, 2018	June 8, 2017

## 12. Commitments and Contingencies

### *Severance Payments*

We have agreements with key personnel that provide for severance payments to them in the event of a change in control of the Company, as defined in those agreements, and their employment is terminated in connection with that change in control. In such event, our aggregate severance payments to those employees would be \$1.5 million.

### *Contractual Obligations*

We have an obligation under a contract with a third party to make future minimum prepaid royalty payments in the amount of \$800,000 in September 2018 and \$1.2 million in November 2019.

### *Legal and Regulatory Matters*

As previously disclosed in the Company's Current Report on Form 8-K filed on November 15, 2017, on August 9, 2017, a securities class action complaint, *Anthony Giovagnoli v. GlobalSCAPE, Inc., et. al.*, Case No. 5:17-cv-00753, was filed against the Company in the United States District Court for the Western District of Texas. On November 6, 2017, the Court appointed Irfan Rahman as lead plaintiff, and he filed the First Amended Complaint on July 26, 2018. The Amended Complaint names the Company, Matthew Goulet, James Albrecht, Thomas Brown, David Mann, Frank Morgan, and Thomas Hicks as defendants for allegedly making materially false and misleading statements regarding, inter alia, the Company's previously reported financial statements. The Amended Complaint alleges violations of Sections 10(b) and 20(a) of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), and Rule 10b-5 promulgated thereunder. The Amended Complaint seeks unspecified damages, costs, attorneys' fees, and equitable relief. Management intends to vigorously defend against this action. At this time, the Company cannot predict how the courts will rule on the merits of the claims and/or the scope of the potential loss in the event of an adverse outcome. Should the Company ultimately be found liable, the resulting damages could have a material adverse effect on its financial position, liquidity, or results of operations.

On October 20, 2017, the Company received a demand letter from a stockholder seeking the inspection of books and records of the Company pursuant to Section 220 of the Delaware General Corporation Law (the "Section 220 Demand"). This stockholder's stated purpose for the demand is, *inter alia*, to investigate whether the Company's Board of Directors and officers engaged in an illegal scheme to misrepresent the Company's performance by falsely reporting accounts receivable, license revenue, total current assets and total assets, total stockholders' equity, and total liabilities for the year ended December 31, 2016, as well as the Board's independence to consider a stockholder derivative demand. The Company intends to fully respond to the Section 220 Demand to the extent required under Delaware law.

The Board has established a special litigation committee (“Special Litigation Committee”) consisting of Dr. Thomas Hicks and Frank Morgan to analyze and investigate claims that could potentially be asserted in stockholder derivative litigation related to facts connected to the claims and allegations asserted in the litigation related to the Restatement and the Section 220 Demand (the “Potential Derivative Litigation”). The Special Litigation Committee will determine what actions are appropriate and in the best interests of the Company, and decide whether it is in the best interests of the Company to pursue, dismiss, or consensually resolve any claims that may be asserted in the Potential Derivative Litigation. The Board determined that each member of the Special Litigation Committee is disinterested and independent with respect to the Potential Derivative Litigation. Among other things, the Special Litigation Committee has the power to retain counsel and advisors, as appropriate, to assist it in the investigation, to gather and review relevant documents relating to the claims, to interview persons who may have knowledge of the relevant information, to prepare a report setting forth its conclusions and recommended course of action with respect to the Potential Derivative Litigation, and to take any actions, including, without limitation, directing the filing and prosecution of litigation on behalf of the Company, as the Special Litigation Committee in its sole discretion deems to be in the best interests of the Company in connection with the Potential Derivative Litigation. The Special Litigation Committee’s findings and determinations shall be final and not subject to review by the Board and in all respects shall be binding upon the Company.

As disclosed in a Current Report on Form 8-K filed on March 16, 2018, the Fort Worth, Texas Regional Office of the SEC has opened a formal investigation of issues relating to the Restatement, with which the Company is cooperating fully. At this time, the Company is unable to predict the duration, scope, result or related costs associated with the SEC’s investigation. The Company is also unable to predict what, if any, action may be taken by the SEC, or what penalties or remedial actions the SEC may seek. Any determination by the SEC that the Company’s activities were not in compliance with existing laws or regulations, however, could result in the imposition of fines, penalties, disgorgement, equitable relief, or other losses, which could have a material adverse effect on the Company’s financial position, liquidity, or results of operations.

On May 31, 2018, the Company was served with a subpoena issued by a grand jury sitting in the United States District Court for the Western District of Texas (the “Grand Jury Subpoena”). The Grand Jury Subpoena requests all documents and emails relating to the Company’s investigation of the potential improper recognition of software license revenue. The Company intends to fully cooperate with the Grand Jury Subpoena and related investigation being conducted by the United States Attorney’s Office for the Western District of Texas (the “U.S. Attorney’s Investigation”). At this time, the Company is unable to predict the duration, scope, result or related costs of the U.S. Attorney’s Investigation. The Company is also unable to predict what, if any, further action may be taken in connection with the Grand Jury Subpoena and the U.S. Attorney’s Investigation, or what, if any, penalties, sanctions or remedial actions may be sought. Any determination by the U.S. Attorney’s office that the Company’s activities were not in compliance with existing laws or regulations, however, could result in the imposition of fines, penalties, disgorgement, equitable relief, or other losses, which could have a material adverse effect on the Company’s consolidated financial position, liquidity, or results of operations.

### **13. Concentration of Business Volume and Credit Risk**

In order to leverage the resources of third parties, we make our products available for purchase by end users through third-party, channel distributors even though those end users can also purchase those products directly from us. In the 2018 quarter and 2017 quarter, we earned approximately 15% and 12%, respectively, of our revenue from such sales through our largest, third-party, channel distributor. During the 2018 six months and 2017 six months, we earned approximately 14% and 13%, respectively, of our revenue from such sales through our largest, third-party channel distributor. As of June 30, 2018, approximately 23% of our accounts receivable were due from this channel distributor with payment for substantially all such amounts having been received subsequent to that date.

### **14. Segment and Geographic Disclosures**

In accordance with FASB ASC Topic 280, Segment Reporting, we view our operations and manage our business as principally one segment. As a result, the financial information disclosed herein represents all of the material financial information related to our principal operating segment.

Revenues derived from customers and partners located outside the United States accounted for approximately 26% of our total revenues in the 2018 quarter and the 2017 quarter, and 28% and 24% for the 2018 six months and 2017 six months, respectively. Each individual foreign country accounts for less than 10% of total revenues in all periods. We attribute revenues to countries based on the country in which the customer or partner is located. None of our property and equipment was located in a foreign country as of June 30, 2018.

**15. Subsequent Events**

On August 3, 2018, we implemented a plan to restructure our organization, which included a reduction in workforce of approximately 40 employees. We will record a charge of approximately \$400,000 in the third quarter of 2018 relating to this reduction in force, consisting primarily of one-time severance payments and termination benefits.

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

This Quarterly Report on Form 10-Q and any documents incorporated by reference herein contain “forward-looking statements” within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Exchange Act. “Forward-looking statements” are those statements that are not of historical fact but describe management’s beliefs and expectations. We have identified many of the forward-looking statements in this Quarterly Report by using words such as “anticipate,” “believe,” “could,” “estimate,” “may,” “expect,” “potentially” and “intend.” Although we believe these expectations are reasonable, our operations involve a number of risks and uncertainties, including those described in the “Risk Factors” section of our 2017 Form 10-K and other documents filed with the Securities and Exchange Commission. Therefore, GlobalSCAPE’s actual results of operations and financial condition in the future could differ materially from those discussed in this Quarterly Report.

In the following discussion, our references to the 2018 quarter and the 2017 quarter refer to the three months ended June 30, 2018 and 2017, respectively. Our references to the 2018 six months and the 2017 six months refer to the six months ended June 30, 2018 and 2017, respectively.

### Overview

We develop and sell computer software that provides secure information exchange, data transfer and sharing capabilities for enterprises and consumers. We have been in business for more than twenty years having sold our products to thousands of enterprises and more than one million individual consumers globally.

Our primary business is selling and supporting managed file transfer, or MFT, software for enterprises. MFT software facilitates the transfer of data from one location to another across a computer network within a single enterprise or between multiple computer networks in multiple enterprises.

Our MFT products are based upon our Enhanced File Transfer, or EFT, platform. This platform emphasizes secure and efficient data exchange for virtually any organization. It enables business partners, customers and employees to share information safely and securely. The EFT platform provides enterprise-level security while automating the integration of back-end systems which are features often missing from traditional file transfer software. The EFT platform features built-in regulatory compliance, governance, and visibility controls to maintain data safety and security. It can replace legacy systems, homegrown servers, expensive leased lines and virtual area networks, all of which can be insecure, with a top-performing, scalable alternative. The EFT platform promotes ease of administration while providing the detailed capabilities necessary for complete control of a file transfer system.

We earn most of our revenue from the sale of products and services that are part of our EFT platform. Our customers can purchase the capabilities of our EFT platform in two ways:

- Under a perpetual software license for which they pay a one-time fee and under which they typically install our product on computers that they own and/or manage. Our brand name for this product is EFT. Almost all customers who purchase EFT also purchase a maintenance and support, or M&S, contract for which they pay us an annual recurring fee. Most of the revenue we have earned from our EFT platform products has been from sales of perpetual software licenses and related M&S.
- As a software-as-a-service, or SaaS, under which they pay us ongoing fees to access the capabilities of the EFT platform in the cloud. Through 2017, EFT Cloud was our SaaS offering of the EFT platform which users accessed for a flat monthly subscription fee. In January 2018, we introduced EFT Arcus, our SaaS offering of the EFT platform going forward, for which users will pay a base monthly subscription fee plus an additional variable amount determined based upon their metered usage of EFT Arcus resources.

We sell other products that are synergistic to our EFT platform including Mail Express, WAFS, and CuteFTP. Collectively, these products constituted less than 5% of our total revenue in the three months and six months ended June 30, 2018. Customers pay a one-time fee to purchase these products under a perpetual software license. Some customers also purchase an M&S contract. We do not offer a SaaS version of these products and have no plans to do so.

We focus on selling our EFT platform products in a business-to-business environment. The majority of the resources we will expend in the future for product research, development, marketing and sales will focus on this product line. We expect to expend minimal resources developing and selling our other products. We believe our EFT platform products and business capabilities are well-positioned to compete effectively in the market for these products. For a more comprehensive discussion of the products we sell and the services we offer, see *Software Products and Services* below.

As a corporation, we have won multiple awards for performance and reputation, including:

- In 2018:
  - Gold winner in the IT World Network Product Guide Awards
  - Recognized for two Info Security Products Guide 2018 Global Excellence Awards for distinguished achievements in product innovation in categories that included:
    - BYOD/Security Category (Gold Winner) – EFT Workspaces v 7.4.2.
    - Innovations in Compliance Category (Bronze Winner) – EFT v 7.4.2.
  - Amy Hensiek recognized as one of CRN's 2018 Women of the Channel.
  - Named to The Channel Company's list of CRN Channel Chiefs as top leaders in the IT channel for the 5th consecutive year.
  - Awarded a 5-star rating in The Channel Company's 2018 CRN Partner Program Guide for the 4<sup>th</sup> consecutive year.
- In 2017:
  - Named to the CRN 2017 Cloud Partner Program Guide which recognizes partner programs with distinguished margins, sales support and cloud resources
  - Received three awards from the 2017 Golden Bridge Awards for distinguished technology achievements which included:
    - Cloud/SaaS Innovations (Gold Winner) – EFT on Amazon Web Services or Microsoft Azure.
    - Managed File Transfer Innovations (Gold Winner) – The EFT Accelerate module.
    - Governance, Risk and Compliance Innovations (Bronze Winner) – EFT platform.
  - Received two awards from the Network Product Guide 2017 IT World Awards for achievements in product excellence that included:
    - Governance, Risk and Compliance (Gold Winner) – EFT.
    - Cloud Security (Silver Winner) – EFT Cloud Services.
  - Recognized as a Best Place to Work in IT by *Computerworld* for the fourth consecutive year and sixth time overall.
  - Recognized for three Info Security Products Guide 2017 Global Excellence Awards for distinguished achievements in product innovation in categories that included:
    - Innovation in Compliance (Gold Winner) – Enhanced File Transfer.
    - Cloud/SaaS Solutions (Gold Winner) – EFT Cloud Services.
    - BYOD Security (Bronze Winner) – EFT Workspaces.
  - Honored as a Best Company to Work for in Texas by Best Companies Group (BCG), Texas Monthly, the Texas Association of Businesses (TAB), and *Texas SHRM*.
  - Received a 5-Star rating in The Channel Company's CRN 2017 Partner Program Guide for the third year in a row.
  - Honored with the 2017 Total Rewards & Benefits Excellence Award by the HRO Today Services and Technology Association.
  - Selected as a finalist in the 2017 Cybersecurity Product Awards Secure File Transfer: EFT Enterprise.

## Key Business Metrics

We review two key business metrics on an ongoing basis to help us monitor our performance and to identify material trends which may affect our business: revenue growth and adjusted EBITDA.

## **Revenue Growth**

We believe annual revenue growth is a key metric for monitoring our continued success in developing our business in future periods. Given our diverse solution portfolio, we regularly review our revenue mix and changes in revenue across all solutions to identify emerging trends. We believe our revenue growth is primarily dependent upon executing our business strategies which include:

- Ongoing innovation of our EFT platform to address the expanding needs of our existing customers and to enhance our products' appeal to new customers.
- Licensing, developing and/or acquiring technologies with features and functions that are complementary to and synergistic with our EFT platform so as to expand the breadth of our products offerings.
- Enhancing our sales and marketing programs to improve identification of potential demand for our products and to increase the rate at which we are successful in selling our products.

We remain alert for attractive opportunities to collaborate with others or perhaps combine other revenue-producing technologies with ours to expand our product offerings and reach. To that end, we continually assess products and services offered by others that might be synergistic with our existing products. We may elect to take advantage of those opportunities through cooperative marketing agreements or licensing arrangements or by acquiring an ownership position in the enterprise offering the opportunity.

In continuing to develop our demand generation activities, we have made and continue to make ongoing changes in sales and marketing including:

- Aligning our sales group to enhance its industry and geographic focus.
- Implementing new sales and marketing campaigns.
- Enhancing our support of channel partners and engaging them to sell our products through training, orientation and marketing programs.

When we sell our licensed products, we also typically create a recurring revenue stream from M&S since almost all purchasers of our licensed enterprise products also purchase an M&S contract. Most of our M&S contracts are for one year although we also sell multi-year contracts. The customer pays us the M&S fee for the entire term of the agreement at the time the contract begins. We recognize that amount as revenue ratably in future periods over the term of the contract.

We typically experience a high renewal rate for M&S services for our enterprise products so long as a customer continues using the licensed product they purchased from us. As a result, growing license revenue not only contributes to increasing revenue growth at the time the license is sold but also provides a foundation for future recurring revenue as the purchasers of our licensed products renew M&S contracts to support their ongoing product support needs. This pattern of activity can create a cumulative effect for M&S renewals as a result of the cumulative number of licensed software installations sold over multiple years that create M&S renewals in any single year predictably (and in line with our expectations) exceeding the number of new software licenses we sell in a single year. We expect this cumulative effect to continue to grow if we continue to increase enterprise software license revenue in future periods. For these reasons, we expect M&S revenue will remain a substantial part of our total revenue.

See *Comparison of the Consolidated Statement of Operations for the Three Months Ended June 30, 2018 and 2017* and *Comparison of the Consolidated Statement of Operations for the Six Months Ended June 30, 2018 and 2017* for a discussion of trends in our revenue growth that we monitor using this metric.

In the past, we reported bookings and potential future revenue as key business metrics. With the refinement of our revenue growth key business metric discussed above, we no longer rely on bookings or potential future revenue as key business metrics since we have determined that our revenue growth metric is the primary metric upon which we rely to measure the success of sales and marketing programs and our outlook for revenue in the future.

**Adjusted EBITDA (Non-GAAP Measurement)**

We utilize Adjusted EBITDA (Earnings Before Interest, Taxes, Total Other Income/Expense, Depreciation, Amortization, other than amortization of capitalized software development costs, and Share-Based Compensation Expense) to provide us a view of income and expenses that is supplemental and secondary to our primary assessment of net income as presented in our consolidated statement of operations and comprehensive income (loss). We use Adjusted EBITDA to provide another perspective for measuring profitability that does not include the effects of the following items:

- Expenses that typically do not require us to pay them in cash in the current period (such as depreciation, amortization and share-based compensation);
- The cost of financing our business; and
- The effects of income taxes.

We monitor Adjusted EBITDA to assess our performance relative to our intended strategies, expected patterns of action, and budgets. We use the results of that assessment to adjust our future activities to the extent we deem necessary.

Adjusted EBITDA is not a measure of financial performance under GAAP. It should not be considered as a substitute for net income (loss) presented on our consolidated statement of operations and comprehensive income (loss). Adjusted EBITDA has limitations as an analytical tool and when assessing our operating performance. Adjusted EBITDA should not be considered in isolation or without a simultaneous reading and consideration of our consolidated financial statements prepared in accordance with GAAP.

We compute Adjusted EBITDA as follows ( \$in thousands):

	<b>Three Months Ended</b>		<b>Six Months Ended</b>	
	<b>June 30,</b>		<b>June 30,</b>	
	<b>2018</b>	<b>2017</b>	<b>2018</b>	<b>2017</b>
Net Income (loss)	\$ 593	\$ 457	\$ (342)	\$ 1,288
Add (subtract) items to determine Adjusted EBITDA:				
Income tax expense	336	265	105	676
Interest (income) expense, net	(80)	(77)	(156)	(146)
Depreciation and amortization:				
Total depreciation and amortization	525	516	1,120	1,056
Amortization of capitalized software development costs	(464)	(446)	(999)	(920)
Share-based compensation expense	191	335	862	671
Adjusted EBITDA	<u>\$ 1,101</u>	<u>\$ 1,050</u>	<u>\$ 590</u>	<u>\$ 2,625</u>

See *Comparison of the Consolidated Statement of Operations for the Three Months Ended June 30, 2018 and 2017* and *Comparison of the Consolidated Statement of Operations for the Six Months Ended June 30, 2018 and 2017* for discussion of the variances between periods in the components comprising Adjusted EBITDA.

**Software Products and Services**

We develop and sell computer software that provides secure information exchange, data transfer, and data sharing capabilities for enterprises and consumers. We have been in business for more than twenty years having sold our products to thousands of enterprises and more than one million individual consumers globally.

Our primary business is selling and supporting MFT software for enterprises. MFT software facilitates the transfer of data from one location to another across a computer network within a single enterprise or between multiple computer networks in multiple enterprises. These transfers may be ongoing, repetitive activities executed by automated software routines that occur without human intervention, or they may be transfers that people create and complete in the absence of automated routines or as a result of ad-hoc, special situations that arise from time-to-time. Examples of enterprise-level activities that rely on MFT software include:

- Transfer of transactional information within an enterprise on a repetitive basis from one geographic location to another, such as a transfer of deposit and withdrawal information throughout the day from a branch of a bank to a central data processing center at another location.



- Movement of accumulated information within an enterprise from one data processing application to another on a periodic basis, such as a transfer of bi-weekly payroll information from a payroll system that is used to pay employees to a job cost system that is used to manage the cost of a project.
- Exchange of information between enterprises to facilitate the completion of one or more business transactions, such as a retailer transmitting inventory purchasing requirements produced by its material requirements planning system to an order entry system at a supplying vendor.

We earn over 90% of our revenue from the sale of MFT products and services that are part of our EFT platform. We have multiple revenue streams from the EFT platform that include:

- Perpetual software licenses under which customers pay us a one-time fee for the right to install our products in their information systems environment on computers they manage and either own or otherwise procure from a cloud services provider, including deploying our products at a cloud services provider in a bring-your-own-license, or BYOL, environment. Our brand name for this product is EFT. Historically, most of the revenue we have earned from our EFT platform products has been from sales of EFT perpetual software licenses and related M&S.
- Cloud-based, SaaS solutions that we sell on an ongoing subscription basis. Through the end of 2017, EFT Cloud was our SaaS offering of the EFT platform which users accessed for a flat monthly subscription fee. In January 2018, we introduced EFT Arcus, our SaaS offering of the EFT platform going forward, for which users will pay a base monthly subscription fee plus an additional variable amount based upon their metered usage of EFT Arcus resources.
- M&S.
- Professional services for product installation, integration and training.

We focus on selling our EFT platform products in a business-to-business environment. The majority of the resources we will expend in the future for product research, development, marketing and sales will focus on this product line. We expect to expend minimal resources developing and selling our other products. We believe our EFT platform products and business capabilities are well-positioned to compete effectively in the market for these products. For a more comprehensive discussion of the products we sell and the services we offer, see below.

In June 2017, we introduced a data integration product that we planned to sell under the brand name Kenetix. We licensed the technology for this product from a third party. We have experienced issues with the third-party technology and have determined to suspend marketing of the product as we evaluate options and determine whether the licensor can effectively address the issues.

We earn less than 5% of our revenue from selling other products that can be synergistic to our EFT platform. These products have capabilities that:

- Support information sharing and exchange capabilities using traditional email systems.
- Enable enterprise file synchronization and sharing.
- Enhance the ability to replicate, share and backup files within a wide area network or local area network, thereby allowing users to access their data at higher speeds than possible with most alternate approaches.
- Support file transfers by individuals and small businesses.

We earn most of our revenue from the sale of our EFT platform products that support business-to-business activities and are strategically focused on selling products in that environment. We intend to expend the majority of our resources in the future for product research and development, marketing, and sales in a manner that concentrates on the business-to-business market and more specifically catering to the needs of our existing customer base. We believe our products and business capabilities are well-positioned to compete effectively in that market.

Some of our products support consumer-oriented file transfers and file sharing. Even though these products are profitable on an overall basis, we anticipate the future resources we will expend related to products sold to consumers and the associated revenue we earn from those products will continue to be a minor part of our business.

Our long-standing vision has been to simply and securely automate the flow of information between people, places and applications. Using that vision as a foundation, in 2018 we introduced a fundamentally new brand identity, logo and narrative that embodies our plan to evolve to being primarily a cloud software and services provider. EFT Arcus is the foundation of that evolution. In addition, we adopted a new visual identity built upon a new tagline: “Make Business Flow Brilliantly”. Our visual theme now features a shifting background wave of colors representing the perpetual flow of data both within and between enterprises using our technology as a conduit through which the flow of business and the data it creates can be managed, monitored, controlled and viewed in a secure manner.

The following discussion presents a summary description of our specific products and solutions.

### **Managed File Transfer – Enhanced File Transfer Platform**

Enhanced File Transfer, or EFT, is the brand name of our core MFT product platform. Our EFT platform products received multiple industry awards in compliance categories in 2018 and 2017, including the 2018 and 2017 Info Security Products Guide Global Excellence Awards, the 2017 Golden Bridge awards and the Network Product Guide's 2017 IT World Awards.

The EFT platform provides users the ability to securely transmit data from one location to another using any number of files of any size or configuration. It facilitates management, monitoring, and reporting on file transfers and delivers advanced data transfer workflow capabilities to move data and information into, out of, and throughout an enterprise.

The EFT platform provides a common, scalable MFT environment that accommodates a broad family of accompanying modules to provide enterprises with increased security, automation, and performance when compared to traditional FTP-based and email delivery systems. Various optional modules allow users to select the solution configuration most applicable to their requirements for auditing and reporting, encryption, ad hoc and web-based file transfers, operability in or through a DMZ network, and integration with back-end business processes, including workflow automation capabilities.

General features and capabilities of the EFT platform include:

- State-of-the-art, enterprise-level security when transferring information within or between computer networks as well as for collaboration with business partners, customers, and employees. EFT provides automation that supports effective integration of back-end systems. It has built-in regulatory compliance, governance, and visibility controls to provide a means of safely maintaining information. EFT offers a high level of performance and scalability to support operational efficiency and maintain business continuity. Administrative tools are provided at various levels of granularity to allow for complete control and monitoring of file transfer activities.
- Transmission of critical information such as financial data, medical records, customer files, vendor files, personnel files, transaction activity, and other similar documents between diverse and geographically separated network infrastructures while supporting a range of information protection approaches to meet privacy and other security requirements. In addition to enabling the secure, flexible transmission of critical information using servers, desktop, and notebook computers and a wide range of network-enabled mobile devices, our products also provide customers with the ability to monitor and audit file transfer activities.
- Compliance with government regulations and industry standards relating to the protection of information while allowing users to reduce information systems and technologies costs, increase efficiency, track and audit transactions, and automate processes. Our solutions also provide data replication, acceleration of file transfer, sharing/collaboration, and continuous data backup and recovery.

During 2017 and the first six months of 2018, we continued to improve the features and capabilities of the EFT platform and announced several product upgrades that included:

- EFT Insight, a new reporting platform to strengthen data governance and provide near real-time visibility into business critical data flows and exchanges.
- Cloud storage support capabilities with the Cloud Connector Module.
- Remote Agent Module for streamlining and centrally managing the data exchanges with branch offices and remote locations.
- Major enhancements for clustering and High Availability configuration.
- Over a dozen major features in the Workspaces module to enhance sharing and collaboration capabilities.
- Enhanced Web Transfer Client user access to improve user experience.
- Improved SFTP security setting configuration to enable more visibility into security settings and help administrators ensure compliance.
- Major update to the Advanced Workflow Engine (AWE) module.
- New security features, including DMZ Gateway module enhancements and updates.

We expect to continue enhancing the EFT platform with capabilities that improve its speed and responsiveness of performance, provide additional administration flexibility supporting cross-platform implementation with our DMZ Gateway solution, offer more robust reporting capabilities, and provide additional language support.

### EFT Platform – Delivery Offerings

Our customers can purchase the capabilities of our EFT platform in two ways:

- Under a perpetual software license for which they pay a one-time fee and under which they typically install our product on computers that they own and/or manage. The EFT platform purchased in this manner can also be used in a bring-your-own-license environment hosted by major cloud providers such as Amazon Web Services or Microsoft Azure. Almost all customers who purchase a perpetual license to use the EFT platform also purchase an M&S contract for which they pay us a recurring fee that is typically 20% to 30% of the perpetual license fee per year.
- As a software-as-a-service, or SaaS, under which the customer pays us monthly subscription and usage fees to access the capabilities of the EFT platform in the cloud. Our brand name for this product is EFT Arcus. We introduced this product in January 2018. We have not yet earned significant revenue from the SaaS offering of our EFT platform.

### Secure Information Sharing and Exchange Solution – Mail Express

Mail Express is a solution that provides secure information sharing and exchange capabilities leveraging traditional email workflow. It is a stand-alone product installed in a client-server environment that allows users to send and receive secure, encrypted email and attachments of virtually unlimited size. Mail Express was a Bronze Winner in Email Security and Management by Network Products Guide's 2016 IT World Awards.

To broaden the appeal and capabilities of Mail Express, we continue to develop and add functionality that integrates the features of Mail Express into the EFT platform through the Workspaces Microsoft® Outlook Plugin. This integration takes the superior control, visibility and monitoring capabilities of the EFT platform and makes them available to administrators and users in an email environment. The Workspaces Microsoft® Outlook Plugin combines the technology and features available in Mail Express with the functionality of Workspaces and integrates them directly into EFT Enterprise.

### Wide Area File Services Solution - WAFS

Our WAFS software product uses data synchronization to further enhance the ability to replicate, share and backup files within a wide area network or local area network thereby allowing users to access their data at higher speeds than possible with most alternate approaches. The software uses byte-level differencing technology to update changes to files with minimal impact on network bandwidth while also ensuring that files are never overwritten, even if opened by other remote users. Other key features of WAFS include native file locking, replication to multiple locations simultaneously, adherence to access control list file permissions, and full UTF-8 support.

We will continue to offer WAFS as a stand-alone product and provide M&S services to customers who purchased WAFS in the past and who purchase it in the future. We do not expect to expend significant resources in the future expanding the features and capabilities of WAFS.

### File Transfer Solution for Consumers - CuteFTP

CuteFTP is our original product introduced in 1996. It is a file transfer program generally used by individuals and small businesses. It remains popular today and generates incremental revenue for us at a relatively low cost.

CuteFTP continues to have significant brand recognition in the market. Our current CuteFTP Version 9 introduced several notable new features including:

- Support for Unicode (UTF-8) characters that allows greater international use.
- Web Distributed Authoring and Versioning (WebDAV) support to facilitate collaboration between users in editing and managing documents and files stored on World Wide Web servers.

Version 9 simplified our CuteFTP product line by consolidating all the features of our previous multi-product CuteFTP product line for Windows operating systems into this single version. We continue to offer CuteFTP Version 3.1 software for Mac platforms. We believe current versions of CuteFTP appeal to users wanting features more robust than offered in free alternatives such that it will be a product competitive in the marketplace for the foreseeable future.

We will continue selling CuteFTP as a stand-alone product and providing M&S services to customers who purchased CuteFTP in the past and who purchase it in the future, but we will not invest significantly in marketing the product. We do not expect to expend significant resources in the future expanding the features and capabilities of CuteFTP.

### **Professional Services**

We offer a range of professional services to complement our on-premises and SaaS solutions. These professional services include system integration, solution “quickstart” implementations, business process and workflow, policy development, education and training, and solution health checks. In addition, we may provide longer-term engineering services, including supporting multi-year contracts, if necessary, to support certain solution implementations and integrations.

### **Maintenance and Support**

We offer M&S contracts to licensees of all of our software products. These M&S contracts entitle the licensee to software upgrades and technical support services in accordance with the terms of our M&S contract. Standard technical support services are provided via email and telephone during our regular business hours. For certain of our products, we offer a Platinum M&S contract which provides access to emergency technical assistance 24 hours per day, 7 days a week.

Most of our M&S contracts are for one year although we also sell multi-year contracts. M&S is purchased by substantially all buyers of our EFT platform as well as by many customers who purchase our other products. Customers with M&S contracts pay us a recurring, annual amount that is typically 20% to 30% of the software license price. A majority of our customers with M&S contracts renew them each year.

### **Employees**

Our number of employees is as follows:

Department	June 30,	
	2018	2017
Sales and Marketing	54	53
Engineering	27	34
Professional Services	5	7
Customer Support	25	23
Management and Administration	17	20
Total	<u>128</u>	<u>137</u>

As a result of the reduction in force described in Note 15 to our condensed consolidated financial statements and also in Item 5 of this filing, we had a total of 94 employees as of August 9, 2018.

### Solution Perspective and Trends

The components of our revenue are as follows ( \$ in thousands):

	Three Months Ended June 30,				Six Months Ended June 30,			
	2018		2017		2018		2017	
	Amount	Percent of Total	Amount	Percent of Total	Amount	Percent of Total	Amount	Percent of Total
<b>Revenue By Type</b>								
License	\$ 2,722	32.2%	\$ 2,700	31.9%	\$ 4,882	30.2%	\$ 5,279	31.2%
M&S	5,285	62.5%	5,222	61.6%	10,385	64.2%	10,343	61.2%
Professional Services	449	5.3%	551	6.5%	900	5.6%	1,283	7.6%
<b>Total Revenue</b>	<b>\$ 8,456</b>	<b>100.0%</b>	<b>\$ 8,473</b>	<b>100.0%</b>	<b>\$ 16,167</b>	<b>100.0%</b>	<b>\$ 16,905</b>	<b>100.0%</b>

#### Revenue by Product Line

<b>License</b>								
EFT Platform	\$ 2,635	96.8%	\$ 2,551	94.5%	\$ 4,711	96.5%	\$ 4,950	93.8%
Other	87	3.2%	149	5.5%	171	3.5%	329	6.2%
<b>Total License Revenue</b>	<b>2,722</b>	<b>100.0%</b>	<b>2,700</b>	<b>100.0%</b>	<b>4,882</b>	<b>100.0%</b>	<b>5,279</b>	<b>100.0%</b>
<b>M&amp;S</b>								
EFT Platform	5,064	95.8%	4,953	94.8%	9,933	95.6%	9,794	94.7%
Other	221	4.2%	269	5.2%	452	4.4%	549	5.3%
<b>Total M&amp;S Revenue</b>	<b>5,285</b>	<b>100.0%</b>	<b>5,222</b>	<b>100.0%</b>	<b>10,385</b>	<b>100.0%</b>	<b>10,343</b>	<b>100.0%</b>
<b>Professional Services (all EFT Platform)</b>								
	449	100.0%	551	100.0%	900	100.0%	1,283	100.0%
<b>Total Revenue</b>								
EFT Platform	8,148	96.4%	8,055	95.1%	15,544	96.1%	16,027	94.8%
Other	308	3.6%	418	4.9%	623	3.9%	878	5.2%
<b>Total Revenue</b>	<b>\$ 8,456</b>	<b>100.0%</b>	<b>\$ 8,473</b>	<b>100.0%</b>	<b>\$ 16,167</b>	<b>100.0%</b>	<b>\$ 16,905</b>	<b>100.0%</b>

Revenue from our EFT platform products increased 1.2% for the 2018 quarter compared to the 2017 quarter and decreased 3.0% for the 2018 six months compared to the 2017 six months. Revenue for our other product lines decreased 26.3% for the 2018 quarter compared to the 2017 quarter and 29.0% for the 2018 six months compared to the 2017 six months, which is consistent with our expectations as discussed below. For a more detailed discussion of these revenue trends, see *Comparison of the Consolidated Statement of Operations for the Three Months Ended June 30, 2018 and 2017* and *Comparison of the Consolidated Statement of Operations for the Six Months Ended June 30, 2018 and 2017*.

We earn revenue primarily from the following activities:

- License revenue from sales of our EFT platform products that we deliver as either perpetually-licensed software installed at the customer's premises, for which we earn the full amount of the license revenue at the time the license is delivered, or as a cloud-based service under our EFT Cloud Services or EFT Arcus brands delivered using a SaaS model, for which we earn monthly subscription revenue as these services are delivered.
- License revenue from sales of our Mail Express, WAFS and CuteFTP products that are installed at the customer's premises under a perpetual license for which we earn the full amount of the license revenue at the time the license is delivered.
- M&S revenue under contracts to provide ongoing product support and software updates to our customers who have purchased license software which we recognize ratably over the contractual period, which is typically one year, but can be up to three years.
- Professional services revenue from a variety of implementation and integration services, as well as delivery of education and training associated with our solutions, which we recognize as the services are performed and accepted by the client.

We earn most of our revenue from the sale of our EFT platform products and the associated M&S and professional services related to those products. With our core competency being in products that address the MFT market, we believe our EFT platform products provide the best opportunity for our future growth. Accordingly, expansion of the capabilities of the EFT platform will be our primary focus in the future. While we will continue to sell and support our other products for the foreseeable future, they will not be an area of emphasis for us going forward.

We believe that continuing to offer licensed products installed on-premises for which we recognize revenue up-front and that carry with them a recurring M&S revenue stream is important to our future success. At the same time, we recognize that a migration of capabilities to a SaaS platform is attractive to a growing number of customers. We have, and have had for quite some time, the capabilities in place to deliver our EFT platform in that manner through our EFT Cloud and Arcus products. While our SaaS revenue is not yet a material component of our total revenue, a migration by our customers to our EFT Cloud and Arcus products could create some near-term decreases in the growth rate of license revenue, and may result in similar decreases in future periods, because it typically takes approximately 24 to 36 months of SaaS revenue to yield total revenue equivalent to that realized up-front from the sale of a license for an on-premise installation.

In mid-2016, we reviewed the allocation of our product research and development resources across all of our products. As a result of that review, we decided to adjust that allocation to focus most of our engineering resources involved in product research and development on our EFT platform products in order to expand their capabilities and to remain positioned to be responsive to the evolving needs of our customers.

We have developed and offered individual product lines throughout our history that include EFT, Mail Express, WAFS, and CuteFTP. Each of these product lines addresses distinct needs in the marketplace. While some customers purchase products from more than one of these product lines, for the most part, customers in a particular market or vertical have needs that are addressed by only one of these products and, therefore, purchase only that product. While we will continue to offer Mail Express as a stand-alone product for the time being, the engineering resources we allocate to this technology will focus on migrating it to becoming an integrated component of our EFT platform. We do not expect to expend significant resources in the future on expanding the features and capabilities of WAFS and CuteFTP although we will continue to sell those products and support them.

In continuing to develop our demand generation activities, we have made and continue to make ongoing changes in sales and marketing including:

- Aligning our sales group to enhance its industry and geographic focus.
- Implementing new sales and marketing campaigns.
- Enhancing our support of channel partners and engaging them to sell our products through training, orientation and marketing programs.

#### Liquidity and Capital Resources

Our total cash, cash equivalents, certificates of deposit and working capital positions were as follows ( \$ in thousands):

	<b>June 30, 2018</b>	<b>December 31, 2017</b>
Cash and cash equivalents	\$ 11,914	\$ 11,583
Short term certificates of deposit	4,311	4,291
Long term certificates of deposit	11,617	11,503
Total cash, cash equivalents and certificates of deposit	<u>\$ 27,842</u>	<u>\$ 27,377</u>
Current assets	\$ 23,144	\$ 23,296
Current liabilities	<u>(16,785)</u>	<u>(16,886)</u>
Working capital	<u>\$ 6,359</u>	<u>\$ 6,410</u>

At June 30, 2018, our certificates of deposit in current assets mature on various dates through October 2018. Our long term certificate of deposit matures in December 2021.

When assessing our liquidity and capital resources, we consider the following factors:

- We may access and monetize our certificates of deposit at any time without risk of loss of the original amounts invested. If we were to redeem these certificates of deposit prior to their maturity, we may incur a penalty and forfeit certain amounts of accrued interest, but we view such amounts as not material.
- Deferred revenue, unlike the other liability components of our working capital, is an obligation we will satisfy by providing services in the future to our customers as part of our ongoing operating activities from which we have historically generated cash flow. Our deferred revenue does not involve a disbursement of cash as a direct payment of that liability although we will incur operating expenses in the future as we deliver those M&S services.

Our capital requirements principally relate to our need to fund our ongoing operating expenditures, which are primarily related to employee salaries and benefits. We make these expenditures to enhance our existing products, develop new products, sell those products in the marketplace and support our customers after the sale.

We rely on cash and cash equivalents on hand and cash flows from operations to fund our operating activities and believe those items will be our principal sources of capital for the foreseeable future. If our revenue declines and/or our expenses increase, our cash flow from operations and cash on hand could decline.

Cash provided or used by our various activities consisted of the following ( \$ in thousands):

	<b>Cash Provided (Used) During the Six Months Ended June 30,</b>	
	<b>2018</b>	<b>2017</b>
Operating activities	\$ 1,883	\$ 1,225
Investing activities	(897)	(1,169)
Financing activities	(655)	(194)

Our cash provided by operating activities increased during the 2018 six months compared to the 2017 six months primarily due to the following factors:

- Accounts receivable decreasing \$1.7 million during the 2018 six months compared to decreasing \$261,000 during the 2017 six months due primarily from increased cash collections from customers and lower sales during the 2018 six months as compared to the 2017 six months.
- Accounts payable increasing \$292,000 during the 2018 six months compared to increasing \$18,000 during the 2017 six months due to increased legal fees incurred in connection with our previously announced internal investigation and the matters discussed in note 12 of the notes to our condensed consolidated financial statements and normal variations in the timing of payments to our vendors.
- Federal income tax receivable increasing \$157,000 in the 2018 six months compared to increasing \$669,000 in the 2017 six months due primarily to paying \$1.3 million more in income tax payments in the 2017 six months as compared to the 2018 six months.
- Deferred revenue decreasing \$1.0 million during the 2018 six months compared to decreasing \$1.3 million during the 2017 six months due primarily to a larger number of M&S sales during the 2018 six months.

Offset by:

- Net income (loss) after considering items not involving cash at the time they are recorded in the statement of operations and comprehensive income (loss), as set forth on our Condensed Consolidated Statements of Cash Flows, decreasing from \$2.9 million in the 2017 six months to \$1.6 million in the 2018 six months. See *Comparison of the Consolidated Statement of Operations for the Six Months Ended June 30, 2018 and 2017* for a discussion of the changes in the components of these amounts.
- Prepaid and other current assets increasing \$389,000 in the 2018 six months compared to decreasing \$106,000 in the 2017 six months due primarily to a receivable related to an insurance claim that did not exist in 2017.

The amount of cash we used for investing activities during the 2018 six months decreased compared to the 2017 six months due primarily to:

- A decrease in the purchase of property and equipment as a result of remodeling of our sales and engineering office spaces in the 2017 six months, for which there was no comparable event in the 2018 six months; and
- A decrease in our software development costs capitalized due to it taking longer than expected to fill open engineering positions with the skillsets needed to support new product development as a result of competition in the marketplace for software engineers.

Financing activities used more cash during the 2018 six months than during the 2017 six months primarily due to a moratorium on issuing shares of our common stock in connection with stock option exercises in the 2018 six months that did not exist in the 2017 six months.

### Contractual Obligations and Commitments

As of June 30, 2018, our contractual obligations and commitments consisted primarily of the following items:

- An obligation to deliver services in the future to satisfy our right to earn our deferred revenue of \$16.0 million. Those future services primarily relate to our obligations under M&S contracts. We will recognize this deferred revenue as revenue over the remaining life of those contracts which generally ranges from one to three years. Deferred revenue, unlike the other liability components of our working capital, is an obligation we will satisfy by providing services in the future to our customers as part of our ongoing operating activities from which we have historically generated cash flow. Our deferred revenue does not involve a disbursement of cash as a direct payment of that liability although we will incur operating expenses in the future as we deliver those M&S services.
- We have an obligation under a contract with a third-party to prepay future minimum royalty payments in the amount of \$800,000 in September 2018 and \$1.2 million in November 2019.
- Trade accounts payable and accrued liabilities which include our contractual obligations to pay software royalties to third parties that vary in amount based on our sales volume of products upon which royalties are payable.
- Operating lease for our office space.
- Federal and state taxes.

Our non-cancellable, contractual obligations at June 30, 2018, consisted primarily of the following ( \$ in thousands):

	<b>Amounts Due for the Period</b>				
	<b>Six Months Ending December 31,</b>	<b>Fiscal Years</b>			
	<b>2018</b>	<b>2019</b>	<b>2020</b>	<b>Thereafter</b>	<b>Total</b>
Prepaid royalty fees	\$ 800	\$ 1,200	\$ -	\$ -	\$ 2,000
Operating leases	180	120	-	-	300
<b>Total</b>	<b>\$ 980</b>	<b>\$ 1,320</b>	<b>\$ -</b>	<b>\$ -</b>	<b>\$ 2,300</b>

As of June 30, 2018, we had no interest-bearing obligations in the form of loans, notes payable or similar debt instruments.

Due to the change in business strategy, more fully described in item 5, we plan to continue to expend resources in the future on product development and sales and marketing, but at a lower rate than in past quarters.



**Comparison of the Consolidated Statement of Operations for the Three Months Ended June 30, 2018 and 2017**

	<b>Three Months Ended June 30,</b>		<b>\$Change</b>
	<b>2018</b>	<b>2017</b>	
	<i>\$in thousands</i>		
Total revenues	\$ 8,456	\$ 8,473	\$ (17)
Total cost of revenues	1,565	1,530	35
Gross profit	6,891	6,943	(52)
Operating expenses			
Sales and marketing	2,889	3,196	(307)
General and administrative	1,470	1,529	(59)
Legal and professional	1,046	360	686
Research and development	637	1,213	(576)
Total operating expenses	6,042	6,298	(256)
Income from operations	849	645	204
Other income	80	77	3
Income before income taxes	929	722	207
Income tax expense	336	265	71
Net income	\$ 593	\$ 457	\$ 136

In the discussion below, we refer to the three months ended June 30, 2018 as the “2018 quarter” and the three months ended June 30, 2017 as the “2017 quarter”. The percentage changes cited in our discussions are based on the 2018 quarter amounts compared to the 2017 quarter amounts.

**Revenue.** The components of our revenues were as follows ( \$in thousands):

	<b>Three Months Ended June 30,</b>			
	<b>2018</b>		<b>2017</b>	
	<b>Amount</b>	<b>Percent of Total</b>	<b>Amount</b>	<b>Percent of Total</b>
<b>Revenue By Type</b>				
License	2,722	32.2%	2,700	31.9%
M&S	5,285	62.5%	5,222	61.6%
Professional Services	449	5.3%	551	6.5%
Total Revenue	\$ 8,456	100.0%	\$ 8,473	100.0%
<b>Revenue by Product Line</b>				
License				
EFT Platform	\$ 2,635	96.8%	\$ 2,551	94.5%
Other	87	3.2%	149	5.5%
	2,722	100.0%	2,700	100.0%
M&S				
EFT Platform	5,064	95.8%	4,953	94.8%
Other	221	4.2%	269	5.2%
	5,285	100.0%	5,222	100.0%
Professional Services (all EFT Platform)	449	100.0%	551	100.0%
Total Revenue				
EFT Platform	8,148	96.4%	8,055	95.1%
Other	308	3.6%	418	4.9%
	\$ 8,456	100.0%	\$ 8,473	100.0%

Our total revenue remained relatively flat. Revenue from our EFT platform products and services increased 1.2%. Revenue from our other products that consist of Mail Express, WAFS, CuteFTP, and TappIn decreased to comprising 3.6% of our total revenue, which is a trend that is in line with our ongoing de-emphasis of those products.

#### *EFT Platform Products*

License revenue from our EFT platform products increased 3.3%. This increase was primarily due to an increase in the number of large transactions, including transactions that were expected to originally close in the previous quarter and a change in our lead generation strategy toward the end of 2017 which led to an increase in selling opportunities in the 2018 quarter.

To improve our ability to successfully sell existing EFT platform products as well as new products produced by our software engineering team, we continued to make, and will continue to make, ongoing changes in sales and marketing personnel and activities including:

- Aligning our sales group to enhance its industry and geographic focus.
- Implementing new sales and marketing campaigns.
- Enhancing our support of channel partners and engaging them to sell our products through training, orientation and marketing programs.

M&S revenue from our EFT platform products increased 2.2% primarily due to:

- Ongoing license sales since a majority of license sales are accompanied by an M&S contract. The change in M&S revenue typically lags behind the related change in license revenue because license sales are recognized as revenue in full in the period the license is delivered while the related M&S revenue is recognized in future periods as those services are delivered.
- Sustaining high renewal rates of M&S contracts by customers who initially purchased these services in earlier periods. We believe these renewals result from our programs designed to provide high-quality and responsive M&S services to our customers.

Our professional services revenue was \$102,000 less for the 2018 quarter compared to the 2017 quarter which is a decrease of 18.5%. This decrease was primarily due to lower headcount in our professional services department which resulted in less resources available to deliver professional services in the 2018 quarter.

When we sell our licensed products, we also typically create a recurring revenue stream from M&S since almost all purchasers of our licensed products also purchase an M&S contract. In general, and depending upon the level of M&S a customer purchases, this recurring revenue stream is 20% to 30% per year of the price of the underlying software license to which the M&S relates.

Our M&S contracts are typically for one year, with some customers buying two or three year contracts. The customer pays us the M&S fee for the entire term of the agreement at the time the contract begins. We recognize that amount as revenue ratably in future periods over the term of the contract.

We typically experience a high renewal rate for M&S services for our enterprise products so long as a customer continues using the licensed product they purchased from us. As a result, growing license revenue not only contributes to increasing revenue growth at the time the license is sold but also provides a foundation for future recurring revenue as the purchasers of our licensed products continually renew M&S contracts to support their ongoing product support needs. This pattern of activity can create a cumulative effect for M&S renewals as a result of the cumulative number of licensed software installations sold over multiple years that create M&S renewals in any single year predictably (and in line with our expectations) exceeding the number of new software licenses we sell in a single year. We expect this cumulative effect to continue to grow if we continue to increase enterprise software license revenue in future periods.

*Other Products*

In mid-2016, we announced that our focus would be on our EFT platform products. At the same time, we announced that while we would continue selling our Mail Express, WAFS, CuteFTP, and TappIn products that collectively constitute less than 3.6% of our total revenue in the quarter, in the future we would de-emphasize these stand-alone products that are not part of our EFT platform. Accordingly, during the second half of 2016, we began to curtail our product development and engineering resources for these products and significantly reduced our sales and marketing activities supporting them. As a result, our license and M&S revenue from those products collectively declined 26.3% in the 2018 quarter compared to the 2017 quarter. Our future focus will be on our EFT platform such that we expect to see a continuing decline in revenue from these other products although we do expect them to continue to produce a modest contribution margin that contributes to our future profitability.

**Cost of Revenues.** These expenses are associated with the production, delivery and support of our products and services. We believe it is most meaningful to view cost of revenues as a percent of the revenues to which those costs relate since many of those costs are variable relative to revenue.

Cost of license revenue consists primarily of:

- Amortization of capitalized software development costs we incur when producing our software products. This amortization begins when a product is ready for general release to the public and generally is an expense that is not directly variable relative to revenue.
- Royalties we pay to use software developed by others for certain features of our products that is generally an expense that is variable relative to revenue.
- Fees we pay to third parties who provide services supporting our SaaS and cloud-based subscription solutions that generally have components that are both variable and not variable relative to revenue.

Cost of M&S revenue and cost of professional services revenue consist primarily of salaries and related costs of our employees and third parties we use to deliver these services.

Cost of software license revenue decreased 2.4% and as a percent of software license revenue was 27.0% in the 2018 quarter compared to 27.9% in the 2017 quarter. These decreases were primarily due to lower royalty expense, which can fluctuate based upon the mix of products sold, offset by slight increases in third party hosting fees for our SaaS products and an increase in amortization of capitalized software development costs.

Cost of M&S revenue as a percent of M&S revenue was 10.2% in the 2018 quarter as compared to 8.1% in the 2017 quarter. Cost of revenue for M&S in absolute dollars increased by 26.8%. These increases were a combination of increasing our headcount in our customer support department and the decision by the U.S. Army to consolidate certain of their operations resulting in the non-renewal of their M&S contract in September of 2017.

Cost of professional services revenue as a percent of that revenue was 65.0% in the 2018 quarter as compared to 64.1% in the 2017 quarter. This variation resulted from the varying scope and mix of the professional services we deliver that can change from period-to-period in response to the circumstances of the customer environments in which we are working. Because the cost of revenue for professional services is highly variable relative to our revenue from our services, this cost in absolute dollars decreased 17.3% due to a decrease in our professional services revenue for the reasons discussed above.

**Sales and Marketing.** We believe it most meaningful to view cost of sales and marketing as a percent of revenues since many of those costs, particularly sales commissions, are variable relative to revenue. These expenses were 34.2% of total revenue for the 2018 quarter compared to 37.7% of total revenue for the 2017 quarter. In absolute dollars these expenses decreased 9.6% due primarily to decreased marketing expenses related to a decrease in our spending for content syndication in order to instead use those resources to enhance our business development representative program.

**General and Administrative.** These expenses decreased 3.9% primarily due to a decrease in share-based compensation.

**Legal and Professional.** These expenses increased 191% or approximately \$686,000 due to increases in professional fees and related expenses associated with the previously disclosed internal investigation, the restatement of certain of our financial statements and related litigation described in note 12 of the notes to our condensed consolidated financial statements.

**Research and Development.** The overall profile of our research and development, or R&D, activities was as follows ( \$in thousands):

	Three Months Ended June 30,	
	2018	2017
R&D expenditures expensed	\$ 637	\$ 1,213
R&D expenditures capitalized	390	476
Total R&D expenditures (non-GAAP measurement)	<u>\$ 1,027</u>	<u>\$ 1,689</u>

Our total R&D expenditures decreased 39.2% primarily due to a reduction of expenses related to researching technologies available from third parties and shortages of qualified software engineers and technical personnel that caused some of our open positions that arise during the normal course of business to take longer to fill.

Total resources expended for R&D set forth above as total R&D expenditures serves to illustrate our total corporate efforts to improve our existing products and to develop new products regardless of whether or not our expenditures for those efforts were expensed or capitalized. Total resources expended for R&D is not a measure of financial performance under GAAP and should not be considered a substitute for R&D expense (set forth above as R&D expenditures expensed) and capitalized software development costs (set forth above as R&D expenditures capitalized) individually. While we believe the non-GAAP, total resources expended for R&D amount provides useful supplemental information regarding our overall corporate product improvement and new product creation activities, there are limitations associated with the use of this non-GAAP measurement. Total resources expended for R&D is a non-GAAP measure not prepared in accordance with GAAP and may not be comparable to similarly titled measures of other companies since there is no standard for preparing this non-GAAP measure. As a result, this non-GAAP measure of total resources expended for R&D has limitations and should not be considered in isolation from, or as a substitute for, R&D expense and capitalized software development costs individually.

**Interest Income (Expense), Net.** Interest income (expense), net consists primarily of interest income earned on certificates of deposit. This income increased 3.9% during the 2018 quarter as compared to the 2017 quarter due to an increase in the rate of interest on certain of our certificates.

**Income Taxes.** Our effective rate differed from the federal statutory tax rate of 21% in the 2018 quarter and 34% in the 2017 quarter primarily due to:

- Certain expenses in our consolidated financial statements, such as a portion of meals and entertainment expenses and stock based compensation that are not deductible on our federal income tax return.
- State income taxes included in income tax expense in our consolidated financial statements.

Offset by:

- The domestic production activities deduction (in the 2017 quarter) and the research and development credit which are tax credit incentives that serve to reduce the rate at which we pay federal income taxes in exchange for us conducting certain aspects of our business in a manner promoted by the Internal Revenue Code.

**Comparison of the Consolidated Statement of Operations for the Six Months Ended June 30, 2018 and 2017**

	<b>Six Months Ended June 30,</b>		<b>\$Change</b>
	<b>2018</b>	<b>2017</b>	
	<i>\$in thousands</i>		
Total revenues	\$ 16,167	\$ 16,905	\$ (738)
Total cost of revenues	3,183	3,064	119
Gross profit	12,984	13,841	(857)
Operating expenses			
Sales and marketing	6,001	6,485	(484)
General and administrative	3,293	3,047	246
Legal and professional	2,725	556	2,169
Research and development	1,358	1,935	(577)
Total operating expenses	13,377	12,023	1,354
Income (loss) from operations	(393)	1,818	(2,211)
Other income	156	146	10
Income (loss) before income taxes	(237)	1,964	(2,201)
Income tax expense	105	676	(571)
Net income (loss)	\$ (342)	\$ 1,288	\$ (1,630)

In the discussion below, we refer to the six months ended June 30, 2018 as the “2018 six months” and the six months ended June 30, 2017 as the “2017 six months.” The percentage changes cited in our discussions are based on the 2018 six month amounts compared to the 2017 six month amounts.

**Revenue.** The components of our revenues were as follows ( \$in thousands):

	<b>Six Months Ended June 30,</b>			
	<b>2018</b>		<b>2017</b>	
	<b>Amount</b>	<b>Percent of Total</b>	<b>Amount</b>	<b>Percent of Total</b>
<b>Revenue By Type</b>				
License	4,882	30.2%	5,279	31.2%
M&S	10,385	64.2%	10,343	61.2%
Professional Services	900	5.6%	1,283	7.6%
Total Revenue	\$ 16,167	100.0%	\$ 16,905	100.0%
<b>Revenue by Product Line</b>				
License				
EFT Platform	\$ 4,711	96.5%	\$ 4,950	93.8%
Other	171	3.5%	329	6.2%
	4,882	100.0%	5,279	100.0%
M&S				
EFT Platform	9,933	95.6%	9,794	94.7%
Other	452	4.4%	549	5.3%
	10,385	100.0%	10,343	100.0%
Professional Services (all EFT Platform)	900	100.0%	1,283	100.0%
Total Revenue				
EFT Platform	15,544	96.1%	16,027	94.8%
Other	623	3.9%	878	5.2%
	\$ 16,167	100.0%	\$ 16,905	100.0%

Our total revenue decreased 4.4%. Revenue from our EFT platform products and services decreased 3.0%. Revenue from our other products that consist of Mail Express, WAFS, CuteFTP, and TappIn decreased to comprising 3.9% of our total revenue, which is a trend that is in line with our ongoing de-emphasis of those products.

#### *EFT Platform Products*

License revenue from our EFT platform products decreased 4.8%. This decrease was primarily due to an unusually large number of potential customers deferring their buying decisions to later periods as a result of their assessment of business factors unique to each of them and a change in our lead generation strategy toward the end of 2017 which lead to a temporary drop in selling opportunities in 2018. While the second half of the 2018 six months saw a marked improvement, it was not enough to offset the effects of these events attributable to the first half of the 2018 six months.

To improve our ability to successfully sell existing EFT platform products as well as new products produced by our software engineering team, we continued to make and will continue to make, ongoing changes in sales and marketing personnel and activities including:

- Aligning our sales group to enhance its industry and geographic focus.
- Implementing new sales and marketing campaigns.
- Enhancing our support of channel partners and engaging them to sell our products through training, orientation and marketing programs.

M&S revenue from our EFT platform products increased 1.4% primarily due to:

- Ongoing license sales since a majority of license sales are accompanied by an M&S contract. The change in M&S revenue typically lags behind the related change in license revenue because license sales are recognized as revenue in full in the period the license is delivered while the related M&S revenue is recognized in future periods as those services are delivered.
- Sustaining high renewal rates of M&S contracts by customers who initially purchased these services in earlier periods. We believe these renewals result from our programs designed to provide high-quality and responsive M&S services to our customers.

Our professional services revenue decreased \$383,000 which is a decrease of 30%. This decrease was primarily related to the decreased license revenue from our EFT platform since there generally is a direct relationship between the licenses our customers purchase and their need for professional services and lower headcount in our professional services department which resulted in less resources available to deliver these services.

When we sell our licensed products, we also typically create a recurring revenue stream from M&S since almost all purchasers of our licensed products also purchase an M&S contract. In general, and depending upon the level of M&S a customer purchases, this recurring revenue stream is 20% to 30% per year of the price of the underlying software license to which the M&S relates.

Our M&S contracts are typically for one year, with some customers buying two or three year contracts. The customer pays us the M&S fee for the entire term of the agreement at the time the contract begins. We recognize that amount as revenue ratably in future periods over the term of the contract.

We typically experience a high renewal rate for M&S services for our enterprise products so long as a customer continues using the licensed product they purchased from us. As a result, growing license revenue not only contributes to increasing revenue growth at the time the license is sold but also provides a foundation for future recurring revenue as the purchasers of our licensed products continually renew M&S contracts to support their ongoing product support needs. This pattern of activity can create a cumulative effect for M&S renewals as a result of the cumulative number of licensed software installations sold over multiple years that create M&S renewals in any single year predictably (and in line with our expectations) exceeding the number of new software licenses we sell in a single year. We expect this cumulative effect to continue to grow if we continue to increase enterprise software license revenue in future periods.

### *Other Products*

In mid-2016, we announced that our focus would be on our EFT platform products. At the same time, we announced that while we would continue selling our Mail Express, WAFS, CuteFTP, and TappIn products that collectively constitute less than 5% of our total revenue, in the future we would de-emphasize these stand-alone products that are not part of our EFT platform. Accordingly, during the second half of 2016, we curtailed our product development and engineering resources for these products and significantly reduced our sales and marketing activities supporting them. As a result, our license and M&S revenue from those products collectively declined 29% in the 2018 six months compared to the 2017 six months. Our future focus will be on our EFT platform such that we expect to see a continuing decline in revenue from these other products although we do expect them to continue to produce a modest contribution margin that contributes to our future profitability.

**Cost of Revenues.** These expenses are associated with the production, delivery and support of our products and services. We believe it is most meaningful to view cost of revenues as a percent of the revenues to which those costs relate since many of those costs are variable relative to revenue.

Cost of license revenue consists primarily of:

- Amortization of capitalized software development costs we incur when producing our software products. This amortization begins when a product is ready for general release to the public and generally is an expense that is not directly variable relative to revenue.
- Royalties we pay to use software developed by others for certain features of our products that is generally an expense that is variable relative to revenue.
- Fees we pay to third parties who provide services supporting our SaaS and cloud-based subscription solutions that generally have components that are both variable and not variable relative to revenue.

Cost of M&S revenue and cost of professional services revenue consist primarily of salaries and related costs of our employees and third parties we use to deliver these services.

Cost of software license revenue was relatively flat and as a percent of software license revenue was 30.8% in the 2018 six months as compared to 28.6% in the 2017 six months. While the change in absolute dollars was minimal, the cost as a percent of the related revenue increased primarily due to the amortization of capitalized software development costs which is a cost that does not fluctuate based upon the number of units sold. The increase in amortization of capitalized software development cost was offset by a combination of lower royalty expense and an increase in third-party hosting fees for our SaaS products which resulted in a negligible decrease in overall costs.

Cost of M&S revenue as a percent of M&S revenue was 10.2% in the 2018 six months as compared to 8.1% in the 2017 six months. Cost of revenue for M&S in absolute dollars increased by 26.7%. These increases were a combination of increasing our headcount in our customer support department and the decision by the U.S. Army to consolidate certain of their operations resulting in the non-renewal of their M&S contract in September of 2017.

Cost of professional services revenue as a percent of that revenue was 68.4% in the 2018 six months as compared to 55.9% in the 2017 six months. This variation resulted from the varying scope and mix of the professional services we deliver that can change from period-to-period in response to the circumstances of the customer environments in which we are working. Because the cost of revenue for professional services is highly variable relative to our revenue from our services, this cost in absolute dollars decreased 14.1% due to a decrease in our professional services revenue for the reasons discussed above.

**Sales and Marketing.** We believe it most meaningful to view cost of sales and marketing as a percent of revenues since many of those costs, particularly sales commissions, are variable relative to revenue. These expenses were 37.1% of total revenue for the 2018 six months compared to 38.4% of total revenue for the 2017 six months. In absolute dollars these expenses decreased 7.5%, due primarily to decreased sales commissions due to lower sales and a change in the way in which we compensate our sales people and decreased marketing expenses due to a decrease in our spending for content syndication in order to instead use those resources to enhance our business development representative program.

**General and Administrative.** These expenses increased 8.1% primarily due to a one-time share based compensation expense related to modification of certain stock options of our former Chief Financial Officer, offset by a credit to bad debt expense as a result of reducing the balance in our allowance for doubtful accounts to better reflect our potential exposure.

**Legal and Professional.** These expenses increased 390% or \$2.2 million due to an increase of professional fees and related expenses associated with the previously disclosed internal investigation, the restatement of certain of our financial statements and related litigation described in note 12 of the notes to our condensed consolidated financial statements

**Research and Development.** The overall profile of our research and development activities was as follows ( \$ in thousands):

	Six Months Ended June 30,	
	2018	2017
R&D expenditures expensed	\$ 1,358	\$ 1,935
R&D expenditures capitalized	792	938
Total R&D expenditures (non-GAAP measurement)	\$ 2,150	\$ 2,873

Our total R&D expenditures decreased 25.2% primarily due to a reduction of expenses related to researching technologies available from third parties and shortages of qualified software engineers and technical personnel that caused some of our open positions that arise during the normal course of business to take longer to fill.

Total resources expended for R&D set forth above as total R&D expenditures serves to illustrate our total corporate efforts to improve our existing products and to develop new products regardless of whether or not our expenditures for those efforts were expensed or capitalized. Total resources expended for R&D is not a measure of financial performance under GAAP and should not be considered a substitute for R&D expense (set forth above as R&D expenditures expensed) and capitalized software development costs (set forth above as R&D expenditures capitalized) individually. While we believe the non-GAAP, total resources expended for R&D amount provides useful supplemental information regarding our overall corporate product improvement and new product creation activities, there are limitations associated with the use of this non-GAAP measurement. Total resources expended for R&D is a non-GAAP measure not prepared in accordance with GAAP and may not be comparable to similarly titled measures of other companies since there is no standard for preparing this non-GAAP measure. As a result, this non-GAAP measure of total resources expended for R&D has limitations and should not be considered in isolation from, or as a substitute for, R&D expense and capitalized software development cost individually.

**Interest Income (Expense), Net.** Other income consists primarily of interest income earned on certificates of deposit. This income increased 6.8% during the 2018 six months as compared to the 2017 six months due to an increase in the rate of interest on certain of our certificates.

**Income Taxes.** Our effective tax rate differed from the federal statutory tax rate of 21% for the 2018 six months and 34% for the 2017 six months primarily due to:

- Certain expenses in our consolidated financial statements, such as a portion of meals and entertainment expenses and stock based compensation that are not deductible on our federal income tax return.
- State income taxes included in income tax expense in our financial statements.

Offset by:

- The domestic production activities deduction (in the 2017 six months) and the research and development credit that are tax credit incentives that serve to reduce the rate at which we pay federal income taxes in exchange for us conducting certain aspects of our business in a manner promoted by the Internal Revenue Code.



### **Item 3. Quantitative and Qualitative Disclosures About Market Risk**

We have not utilized derivative financial instruments or derivative commodity instruments. We do not expect to employ these or other strategies to hedge market risk in the foreseeable future. We may invest our cash in money market funds which are subject to minimal credit and market risk. We believe that the interest rate risk and other relevant market risks associated with these financial instruments are immaterial.

During the 2018 quarter and 2017 quarter, we earned approximately 15% and 12%, respectively, of our revenue from a single third party channel distributor who purchases products from us and resells them to their customers. During the 2018 six months and 2017 six months, we earned approximately 14% and 13%, respectively, of our revenue from the same third-party channel distributor. Approximately 23% of our accounts receivable as of June 30, 2018 were due from this distributor. We have since received payment for substantially all of these accounts receivable.

We earned approximately 26% of our revenue from customers outside the United States during the 2018 quarter and the 2017 quarter, and 28% and 24% for the 2018 six months and 2017 six months, respectively. We receive all revenue in U.S. dollars, so we have no material exchange rate risk with regard to our sales. We charge Value Added Taxes to our non-business customers in the European Union. We remit these taxes periodically in pound sterling. The impact of this currency translation has not been material to our business.

### **Item 4. Controls and Procedures**

#### **Disclosure Controls and Procedures**

Our management, including our President and Chief Executive Officer and our Chief Financial Officer, evaluated our disclosure controls and procedures (as such term is defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the Exchange Act)) as of the end of the period covered by this report. Based on this evaluation, our President and Chief Executive Officer and our Chief Financial Officer concluded that due to material weaknesses in our internal control over financial reporting, the company's disclosure controls and procedures were not effective as of June 30, 2018.

As previously reported in our 2017 Form 10-K, filed with the Securities and Exchange Commission on June 14, 2018, in connection with our assessment of the effectiveness of our internal control over financial reporting at the end of our last fiscal year, management identified the following material weaknesses in our internal control over financial reporting as of December 31, 2017 and is in the process of remediation as of June 30, 2018.

We had material weaknesses in our control environment and monitoring:

- We did not implement effective oversight of our finance and accounting processes (including organizational structure and reporting hierarchy), which impacted our ability to make appropriate decisions regarding revenue recognition.
- We did not effectively design and implement appropriate oversight controls over our period-end financial closing and reporting processes, and our review controls were not sufficient to ensure that errors regarding revenue recognition would be detected.
- We did not effectively monitor (review, evaluate and assess) the risks associated with key internal control activities that provide the revenue information contained in our financial statements.

We had material weaknesses related to internal control monitoring and activities to support the financial reporting process:

- We did not maintain effective controls over the invoicing process to ensure that proper supporting documentation was received prior to preparing invoices.
- We did not maintain effective controls over the revenue recognition process to ensure revenue was only recognized when all four criteria of our revenue recognition policy were met.

This section of Item 4, “Controls and Procedures,” should be read in conjunction with Item 9A, “Controls and Procedures,” included in our 2017 Form 10-K, for additional information on Managements Report on Internal Control over Financial Reporting.

#### **Status of Remediation Plan**

We designed a remediation plan to strengthen our internal control over financial reporting and haven taken, and will continue to take, remediation steps to address the material weaknesses described above. We also continue to take meaningful steps to enhance our disclosure controls and procedures and our internal controls over financial reporting.

Our remediation plan includes the following:

- We have clearly defined and communicated to the sales and finance teams the management-approved, standard terms and conditions that may be offered to customers during the sales process and require appropriate management approval of requested deviations from these standard terms and conditions before a sale is consummated with a customer and a sales invoice is created.
- We have created and implemented a policy communicated to the sales and finance teams clearly stating that all terms and conditions of agreements with customers are to be recorded in writing, communicated to finance and accounting personnel, and recorded in our permanent records prior to the creation of a sales invoice.
- Beginning in September 2018, we intend to conduct periodic training sessions and briefings on a quarterly basis to communicate to our sales and finance teams our policies and procedures regarding our standard terms and conditions that we offer to customers and our policies and procedures related to documentation and approval on any deviations from those standard terms and conditions.
- We have enhanced the breadth and depth of our review of all sales invoices and their underlying supporting documentation. We have performed extensive training sessions with our finance and accounting personnel to review all sales invoices and their underlying supporting documentation to help identify any unusual items which may need further analysis to determine appropriate revenue recognition. We have ensured that all finance and accounting personnel are involved in the recognition of revenue to promote transparency and accuracy.
- We have established a total invoice dollar amount threshold over which finance and accounting personnel must examine all actual invoices and underlying supporting documentation to confirm the purchase by the customer and the appropriate revenue recognition profile.
- We have published guidelines that personnel can reference which set forth the requirements to be met for revenue to be recognized from a sale transaction and will be conducting periodic meetings on a quarterly basis, beginning in the third quarter with the sales and finance teams to educate and remind them of these guidelines.

Our management is monitoring the effectiveness of these and other processes, procedures and controls and will make any further changes deemed appropriate. Our management believes the foregoing actions will effectively remediate the material weaknesses. However, our material weaknesses will not be considered remediated until the above controls are in place for a period of time, the controls are tested and management concludes that these controls are properly designed and operating effectively.

#### **Changes in Internal Control over Financial Reporting**

Except as described above with respect to our remediation plan, there have been no changes in our internal control over financial reporting during the quarter ended June 30, 2018 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

## Part II. Other Information

### Item 1. Legal Proceedings

The information set forth under “Note 12 – Commitments and Contingencies – Legal and Regulatory Matters” to the condensed consolidated financial statements included in Part I, Item 1 of this Form 10-Q is incorporated herein by reference.

### Item 1A. Risk Factors.

In addition to the other information set forth in this report, you should carefully consider the factors discussed in Part I, “Item 1A. Risk Factors” in our 2017 Form 10-K filed with the Securities and Exchange Commission on June 14, 2018. These risk factors could materially affect our business, financial condition or future results, but they are not the only risks facing GlobalSCAPE. Additional risks and uncertainties not currently known to us or that we currently deem to be immaterial also may materially adversely affect our business, financial condition, and/or operating results.

### Item 5. Other Information.

#### Annual Meeting

On August 7, 2018, the Board of Directors of GlobalSCAPE, Inc. (“GlobalSCAPE” or the “Company”) determined that the Company’s 2018 annual meeting of stockholders (the “2018 Annual Meeting”) will be held on October 10, 2018, at 9:00 a.m., local time, at the Company’s corporate headquarters or at such other time and location to be determined by the authorized officers and set forth in the Company’s proxy statement for the 2018 Annual Meeting, and established August 17, 2018 as the record date for determining stockholders entitled to notice of, and to vote at, the 2018 Annual Meeting.

The 2018 Annual Meeting is more than 30 days from the first anniversary of the Company’s 2017 annual meeting of stockholders, which was held on May 10, 2017. As a result, stockholders of the Company who wish to have a proposal considered for inclusion in the Company’s proxy materials for the 2018 Annual Meeting pursuant to Rule 14a-8 under the Securities Exchange Act of 1934, as amended (the “Exchange Act”), must provide written notice that is received by the Corporate Secretary at the Company’s corporate headquarters, 4500 Lockhill-Selma Road, Suite 150, San Antonio, Texas 78249, on or before August 24, 2018, which the Company has determined to be a reasonable time before it expects to make its proxy materials available. Stockholder proposals intended to be considered for inclusion in the Company’s proxy materials for the 2018 Annual Meeting must comply with the requirements, including the deadline set forth above, as well as all the applicable rules and regulations promulgated by the Securities and Exchange Commission under the Exchange Act.

In addition, pursuant to the Company’s bylaws, stockholders who wish to present a proposal of business or nominate a director at the 2018 Annual Meeting but do not intend for the proposal to be included in the Company’s Proxy Statement under Rule 14a-8 must provide written notice that is received by the Corporate Secretary at the Company’s corporate headquarters on or before August 20, 2018. Any such written notice must be directed to the attention of the Company’s Corporate Secretary at the Company’s corporate headquarters and must comply with the applicable provisions of the Company’s bylaws, as amended.

The Company issued a press release announcing the 2018 Annual Meeting on August 8, 2018. A copy of the press release is included as Exhibit 99.1 to this Quarterly Report on Form 10-Q.

#### Strategic Change

On August 8, 2018, the Company announced a set of cost reduction actions designed to concentrate resources on key strategic opportunities. These changes are part of an initiative to focus on the company’s flagship offering of EFT and to be a stronger technological partner to existing customers while remaining agile and responsive to market demands.

The actions in this plan include the Company initiating a targeted reduction of our global workforce by 30%. We made significant reductions in the following areas: Marketing, Sales and Product Development. The majority of the impact is within North America. Additionally, program-level savings will reach into all departments throughout the execution of these actions.

The Company estimates that it will incur total costs in connection with the Restructuring Plan of approximately \$400,000; primarily for severance and termination benefits which will consist of cash expenditures. The Company expects this Restructuring Plan to result in a significant annualized total reduction in spending.

#### **Appointment of Chief Financial Officer**

On August 8, 2018, Karen Young, formerly the Company's Interim Chief Financial Officer, was appointed Chief Financial Officer. In connection with her appointment, Ms. Young's annual salary was set at \$200,000 and the Company agreed to grant Ms. Young options to purchase a total of 100,000 shares of common stock.

Ms. Young will also be eligible for an annual bonus of up to 35% of her annual salary pursuant to the terms of the Company's annual bonus plan. Ms. Young will also receive a one-time bonus of \$5,000.

The Company issued a press release announcing the appointment on August 8, 2018. A copy of the press release is included as Exhibit 99.3 to this Quarterly Report on Form 10-Q.

Ms. Young previously served as GlobalSCAPE's Interim Chief Financial Officer since March 2018 and prior to this she served as the Company's Controller since January 2015. From June 2014 to January 2015, Ms. Young was the owner of a CPA practice in which she provided accounting and managerial consulting services to businesses. Prior to operating her own CPA practice, Ms. Young served as Controller of PIC Business Systems, Inc., a provider of web-based integrated Enterprise Resource Planning solutions, where she worked from May 1995 to August 1999 and again from December 2001 to June 2014. At PIC Business Systems, Inc., Ms. Young prepared the company's financial statements and was responsible for oversight of the company's accounting department and other administrative functions. Between her time at PIC Business Systems, Ms. Young worked for a public accounting firm working mainly in the tax area. Ms. Young began her career at Valero Energy Corporation, an independent petroleum refiner, where she focused on budgeting and forecasting for the company and its subsidiaries.

Ms. Young is a Certified Public Accountant with over 20 years of experience as a corporate controller. She has a B.B.A. in Accounting from The University of Texas at San Antonio and is a member of the Texas Society of Certified Public Accountants.

#### **Item 6. Exhibits**

**(a)** Exhibits

- 31.1 [Certification by Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.](#)
- 31.2 [Certification by Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002](#)
- 32.1 [Certification pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.](#)
- 99.1 [Press Release dated August 8, 2018](#)
- 99.2 [Press Release dated August 7, 2018](#)
- 99.3 [Press Release dated August 8, 2018](#)
- 101 Interactive Data File.

**Signatures**

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

**GLOBALSCAPE, INC.**

August 9, 2018

\_\_\_\_\_  
Date

By: /s/ Karen J. Young

\_\_\_\_\_  
Karen J. Young  
Chief Financial Officer

## CERTIFICATIONS

I, Matthew C. Goulet, certify that:

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

Date: August 9, 2018

/s/ Matthew C. Goulet

Matthew C. Goulet

President and Chief Executive Officer

## CERTIFICATIONS

I, Karen J. Young, certify that:

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

Date: August 9, 2018

/s/ Karen J. Young  
\_\_\_\_\_  
Karen J. Young  
Chief Financial Officer

CERTIFICATE PURSUANT TO 18 U.S.C. SECTION 1350,  
AS ADOPTED PURSUANT TO SECTION 906 OF THE  
SARBANES-OXLEY ACT OF 2002

In connection with the Quarterly Report of GlobalSCAPE, Inc. on Form 10-Q for the period ending June 30, 2018, as filed with the Securities and Exchange Commission on the date hereof (the "Report"), the undersigned, Matthew C. Goulet, Chief Executive Officer and Karen J. Young., Chief Financial Officer, certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that:

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

August 9, 2018

/s/ Matthew C.Goulet

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Matthew C.Goulet  
President and Chief Executive Officer

/s/ Karen J. Young

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Karen J. Young  
Chief Financial Officer



**FOR RELEASE****GlobalSCAPE, Inc. Sets Date for the Company's 2018 Annual Meeting of Stockholders**

**SAN ANTONIO – August 8, 2018** – GlobalSCAPE, Inc. (NYSE American: GSB) (“GlobalSCAPE” or the “Company”), a worldwide leader in the secure movement and integration of data, today announced that its Board of Directors has set the date for the Company’s 2018 annual meeting of stockholders (the “2018 Annual Meeting”) as well as the record date for stockholders eligible to vote at the meeting.

The 2018 Annual Meeting will be held on Wednesday, October 10, 2018, at 9:00 a.m., local time, at the Company’s corporate headquarters located at 4500 Lockhill-Selma Road, Suite 150, San Antonio, Texas 78249, or at such other time and location to be determined by the authorized officers and set forth in the Company’s proxy statement. Stockholders of record as of the close of business on August 17<sup>th</sup>, 2018 will be eligible to vote at the meeting.

The items of business at the 2018 Annual meeting are:

1. The election of two directors who will serve for a term of three years; and
2. Ratification of the appointment of Weaver and Tidwell, LLP as the Company’s independent registered public accounting firm for the year ending December 31, 2018.

Additional information about the 2018 Annual Meeting will be contained in the definitive proxy statement (SEC Form DEF 14A) which will be filed with the U.S. Securities and Exchange Commission on or about August 20, 2018 and in the proxy materials that will be mailed to GlobalSCAPE’s stockholders on or about August 27, 2018.

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**About GlobalSCAPE**

GlobalSCAPE, Inc. (NYSE American: GSB) is a pioneer in securing and automating the movement and integration of data seamlessly in, around and outside your business, between people and places, in and out of the cloud. GlobalSCAPE provides technology that automates your work and secures your data, while giving visibility to those who need it. GlobalSCAPE makes business flow brilliantly. For more information, visit <http://www.GlobalSCAPE.com> or follow the blog and Twitter updates.

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**Safe Harbor Statement**

This press release contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. The words “would,” “exceed,” “should,” “anticipates,” “believe,” “expect,” and variations of such words and similar expressions identify forward-looking statements, but their absence does not mean that a statement is not a forward-looking statement. These forward-looking statements are based upon the Company’s current expectations and are subject to a number of risks, uncertainties and assumptions. The Company undertakes no obligation to update any forward-looking statements, whether as a result of new information, future events or otherwise. Among the important factors that could cause actual results to differ significantly from those expressed or implied by such forward-looking statements are risks that are detailed in the Company’s Annual Report on Form 10-K for the year ended December 31, 2017, filed with the U.S. Securities and Exchange Commission on June 14, 2018; the discovery of additional information relevant to the internal investigation; the conclusions of the Company’s Audit Committee (and the timing of the conclusions) concerning matters relating to the internal investigation; the possibility that additional errors relevant to the recently completed restatement may be identified; pending litigation and other proceedings and the possibility of further legal proceedings adverse to GlobalSCAPE resulting from the restatement or related matters; and the costs associated with the restatement and the investigation.

**GlobalSCAPE Press Contact**

Contact: Lisa Kilpatrick  
Phone Number: (210) 308-8267  
Email: PR@GlobalSCAPE.com

**GlobalSCAPE Investor Relations Contact**

Contact: Matt Glover or Najim Mostamand, CFA  
Phone Number: (949) 574-3860  
Email: IR@GlobalSCAPE.com

**FOR RELEASE****GlobalSCAPE Announces Reduction in Force as Part of Continued Cost Realignment**

**SAN ANTONIO, Texas- August 7, 2018** - GlobalSCAPE, Inc. (NYSE American: GSB) today announced a reduction in force that is expected to generate significant pre-tax savings.

The company has been executing a strategy to streamline its organization around its flagship offering – Enhanced File Transfer™ (EFT™). These changes apply globally, although the changes are mainly focused in North America. Part of this strategy is to enable GlobalSCAPE to better focus on its customers running EFT while remaining agile enough to adjust to market demands.

“GlobalSCAPE is making good progress with its transformation. This reduction in force, while difficult, is an essential part of making the organization a stronger technological partner for our customers, better investment for our shareholders, and a work environment rich with opportunity for our employees,” said Matt Goulet, president and chief executive officer. “We are realigning our sales team to better service our customers and finding more efficient operational processes.”

The reduction will impact approximately 40 employees. Customary transition assistance will be provided to affected employees.

Due to the reduction in force, the company expects to incur total restructuring charges in the third quarter 2018 of approximately \$400,000 on a pre-tax basis.

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# GLOBALSCAPE

## FOR RELEASE

### **Karen Young Promoted to Chief Financial Officer at GlobalSCAPE**

**SAN ANTONIO – AUGUST 8, 2018** – GLOBALSCAPE, INC. (NYSE AMERICAN: GSB), A WORLDWIDE LEADER IN THE SECURE MOVEMENT AND INTEGRATION OF DATA, TODAY ANNOUNCES THE PROMOTION OF KAREN YOUNG TO CHIEF FINANCIAL OFFICER, EFFECTIVE IMMEDIATELY. YOUNG WAS APPOINTED TO THE ROLE OF INTERIM CHIEF FINANCIAL OFFICER IN MARCH OF THIS YEAR, AND SUCCEEDS JAMES ALBRECHT, WHO RETIRED IN FEBRUARY. YOUNG HAS SERVED AS THE CONTROLLER FOR THE PAST THREE YEARS, REPORTING TO ALBRECHT, AND NOW REPORTS TO GLOBALSCAPE CEO, MATT GOULET.

Young joined GlobalSCAPE in 2015 and has been responsible for all accounting functions, including financial planning and budgeting, preparation of financial statements, SEC reporting, management of audits, supervision of accounting functions and tax preparation. Young has also been extremely instrumental in navigating the recently concluded audit committee investigation and financial statement audit. In her role as Interim CFO, Young was responsible for ensuring that GlobalSCAPE regained compliance with NYSE American continued listing standards, and also responsible for the remediation plan designed to strengthen GlobalSCAPE's internal controls over financial reporting.

“Since joining Globalscape, Karen has made significant contributions to the Company, first in her role as Controller, and then as Interim Chief Financial Officer; taking on increased scope and complexity, and establishing and managing a world-class controllership,” said Matt Goulet, president and CEO of GlobalSCAPE. “During her tenure, Karen has been a key leader within Finance, and has played a pivotal role in GlobalSCAPE financial operations, leading us through the very challenging audit committee investigation.”

“With her combination of experience and leadership skills, as well as her thorough knowledge of GlobalSCAPE's financial operations, Karen was the obvious choice as our new CFO. Karen is a great addition to the executive team and has the full confidence of me, our newly expanded Board, and the entire GlobalSCAPE organization,” added Goulet.

Young will direct all fiscal functions of the corporation, ensure compliance with generally accepted accounting principles and SEC regulations, oversee the audit and review function, and assist the executive management team in establishing long-range goals, strategies, plans and policies.

“I am excited to take on increased responsibilities and move into the role of CFO at GlobalSCAPE,” said Young. “I look forward to joining the GlobalSCAPE executive team, and to partnering with the team to develop and implement business strategies that enhance the Company's position as a market leader and add value for our stakeholders; including our investors, employees and customers.”

Young is a Certified Public Accountant and a graduate of The University of Texas at San Antonio with a BBA in Accounting. With over 25 years as a financial professional, Young began her career with Valero Energy Corporation in San Antonio. Prior to joining GlobalSCAPE, Young was the Controller for PIC Business Systems, Inc., and across her career, has served in a variety of finance and accounting roles.

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# GLOBALSCAPE

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