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

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**FORM 10-Q**

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(Mark One)

☒ **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**  
For the quarterly period ended September 30, 2018.

or

☐ **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**  
For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number 001-33601

**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

**210-308-8267**

Registrant's Telephone Number, Including Area Code

\_\_\_\_\_  
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 every Interactive Data File required to be submitted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit 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 ☒

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

As of September 30, 2018 there were 17,968,268 shares of common stock outstanding.

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GlobalSCAPE, Inc.

Quarterly Report on Form 10-Q

For the Quarter ended September 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)

	September 30, 2018 (Unaudited)	December 31, 2017
<b>Assets</b>		
Current assets:		
Cash and cash equivalents	\$ 9,630	\$ 11,583
Certificates of deposit, short term	1,530	4,291
Accounts receivable, net	4,853	5,925
Federal income tax receivable	740	822
Prepaid and other current assets	3,173	675
Total current assets	19,926	23,296
Certificates of deposit, long term	-	11,503
Capitalized software development costs, net	3,384	3,786
Goodwill	12,712	12,712
Deferred tax asset, net	330	651
Property and equipment, net	442	481
Other assets	577	84
Total assets	\$ 37,371	\$ 52,513
<b>Liabilities and Stockholders' Equity</b>		
Current liabilities:		
Accounts payable	\$ 1,982	\$ 1,900
Accrued expenses	3,378	1,671
Deferred revenue	12,341	13,315
Total current liabilities	17,701	16,886
Deferred revenue, non-current portion	2,795	3,735
Other long term liabilities	128	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, 22,382,862 and 22,196,712 shares issued: 17,968,268 and 21,793,131 outstanding at September 30, 2018 and December 31, 2017, respectively	22	22
Additional paid-in capital	25,106	23,793
Treasury stock, 4,414,594 and 403,581 shares, at cost, at September 30, 2018 and December 31, 2017, respectively	(18,714)	(1,452)
Retained earnings	10,333	9,353
Total stockholders' equity	16,747	31,716
Total liabilities and stockholders' equity	\$ 37,371	\$ 52,513

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

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

	<b>Three months ended September 30,</b>		<b>Nine months ended September 30,</b>	
	<b>2018</b>	<b>2017</b>	<b>2018</b>	<b>2017</b>
<b>Operating Revenues:</b>				
Software licenses	\$ 2,843	\$ 2,488	\$ 7,726	\$ 7,768
Maintenance and support	5,488	5,360	15,872	15,702
Professional services	649	368	1,549	1,652
Total Revenues	<u>8,980</u>	<u>8,216</u>	<u>25,147</u>	<u>25,122</u>
<b>Cost of revenues:</b>				
Software licenses	721	725	2,225	2,234
Maintenance and support	514	446	1,574	1,283
Professional services	264	402	880	1,120
Total cost of revenues	<u>1,499</u>	<u>1,573</u>	<u>4,679</u>	<u>4,637</u>
Gross profit	7,481	6,643	20,468	20,485
<b>Operating expenses:</b>				
Sales and marketing	2,261	3,079	8,229	9,564
General and administrative	1,589	1,573	4,883	4,607
Legal and professional	1,510	1,002	4,235	1,550
Severance	381	-	488	21
Research and development	368	594	1,654	2,530
Total operating expenses	<u>6,109</u>	<u>6,248</u>	<u>19,489</u>	<u>18,272</u>
Income from operations	1,372	395	979	2,213
Interest income (expense), net	(93)	75	63	221
Income before income taxes	1,279	470	1,042	2,434
Income tax expense	281	194	386	870
Net income	<u>\$ 998</u>	<u>\$ 276</u>	<u>\$ 656</u>	<u>\$ 1,564</u>
Comprehensive income	<u>\$ 998</u>	<u>\$ 276</u>	<u>\$ 656</u>	<u>\$ 1,564</u>
<b>Net income per common share -</b>				
Basic	\$ 0.05	\$ 0.01	\$ 0.03	\$ 0.07
Diluted	\$ 0.05	\$ 0.01	\$ 0.03	\$ 0.07
<b>Weighted average shares outstanding:</b>				
Basic	21,688	21,792	21,746	21,672
Diluted	21,940	22,247	22,044	22,145

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 Nine Months Ended September 30,</b>	
	<b>2018</b>	<b>2017</b>
Operating Activities:		
Net income	\$ 656	\$ 1,564
Items not involving cash at the time they are recorded in the statement of operations:		
Provision (recoveries) for doubtful accounts receivable	(64)	15
Depreciation and amortization	1,641	1,604
Share-based compensation	972	1,053
Deferred taxes	61	28
Subtotal before changes in operating assets and liabilities	3,266	4,264
Changes in operating assets and liabilities:		
Accounts receivable	1,136	1,798
Prepaid and other current assets	(1,868)	163
Deferred revenue	(1,914)	(1,526)
Accounts payable	82	448
Accrued expenses	1,707	404
Other assets	116	154
Accrued interest receivable	-	(195)
Other long-term liabilities	(48)	22
Federal income tax receivable	82	(759)
Net cash provided by operating activities	2,559	4,773
Investing Activities:		
Software development costs capitalized	(1,057)	(1,464)
Purchase of property and equipment	(143)	(249)
Redemption of Certificates of Deposit	14,264	-
Net cash provided by (used in) investing activities	13,064	(1,713)
Financing Activities:		
Proceeds from exercise of stock options	341	471
Purchase of Treasury Stock	(17,262)	-
Dividends paid	(655)	(979)
Net cash used in financing activities	(17,576)	(508)
Net increase (decrease) in cash	(1,953)	2,552
Cash at beginning of period	11,583	8,895
Cash at end of period	\$ 9,630	\$ 11,447
Supplemental disclosure of cash flow information:		
Cash paid during the period for:		
Interest	\$ -	\$ -
Income tax payments	\$ 238	\$ 1,616

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)*

	<b>Common Stock</b>		<b>Additional</b>	<b>Treasury</b>	<b>Retained</b>	
	<b>Shares</b>	<b>Amount</b>	<b>Paid-in</b>	<b>Stock</b>	<b>Earnings</b>	<b>Total</b>
Balance at December 31, 2016	21,920,912	\$ 22	\$ 21,756	\$ (1,452)	\$ 9,289	29,615
Shares issued upon exercise of stock options	191,500		458			458
Stock-based compensation expense						
Stock options			533			533
Restricted stock	80,000		138			138
Common stock cash dividends, \$0.030 per share					(652)	(652)
Net income					1,288	1,288
Balance at June 30, 2017	<u>22,192,412</u>	<u>\$ 22</u>	<u>\$ 22,885</u>	<u>\$ (1,452)</u>	<u>\$ 9,925</u>	<u>\$ 31,380</u>
Shares issued upon exercise of stock options	4,300		14			14
Stock-based compensation expense						
Stock options			296			296
Restricted stock			85			85
Common stock cash dividends, \$0.015 per share					(327)	(327)
Net income					276	276
Balance at September 30, 2017	<u>22,196,712</u>	<u>\$ 22</u>	<u>\$ 23,280</u>	<u>\$ (1,452)</u>	<u>\$ 9,874</u>	<u>\$ 31,724</u>
Stock-based compensation expense						
Stock options			428			428
Restricted stock			85			85
Common stock cash dividends, \$0.015 per share					(328)	(328)
Net income					(193)	(193)
Balance at December 31, 2017	<u>22,196,712</u>	<u>\$ 22</u>	<u>\$ 23,793</u>	<u>\$ (1,452)</u>	<u>\$ 9,353</u>	<u>\$ 31,716</u>
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, \$0.030 per share					(655)	(655)
Net Income					(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>
Purchase of Treasury Stock				(17,262)		(17,262)
Cancellation of Restricted Stock	(40,000)					-
Shares issued upon exercise of stock options	146,150		341			341
Stock-based compensation expense						
Stock options			110			110
Net Income					998	998
Balance at September 30, 2018	<u>22,382,862</u>	<u>\$ 22</u>	<u>\$ 25,106</u>	<u>\$ (18,714)</u>	<u>\$ 10,333</u>	<u>\$ 16,747</u>

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

**GlobalSCAPE, Inc.****Notes to Condensed Consolidated Financial Statements****As of September 30, 2018 and For the Three and Nine****Months Then Ended****(Unaudited)****1. Nature of Business**

GlobalSCAPE, Inc., together with its wholly-owned subsidiary (collectively referred to as the “Company”, “GlobalSCAPE”, “we”, “us” or “our”), provides 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. We experienced issues with the third-party technology and suspended marketing of the product. We have settled the dispute with the third-party and have accrued a liability in these financial statements in the amount of the settlement, including any anticipated settlement fees.

We also market other products that are synergistic to EFT including Mail Express, WAFS, and CuteFTP. Collectively, these products aimed at consumers and small businesses, 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 September 30, 2018 and 2017, respectively. Our references to the 2018 nine months and the 2017 nine months refer to the nine months ended September 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 Quarterly Report on Form 10-Q, or this Report, 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 for the periods presented or total stockholders' equity at September 30, 2018.

#### *Revenue Recognition*

##### 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, own or otherwise procure from a cloud services provider. Customers also deploy our products with cloud services providers in a BYOL 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, or 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. 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 to 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):

	<b>Three Months Ended September 30,</b>		<b>Nine Months Ended September 30,</b>	
	<b>2018</b>	<b>2017</b>	<b>2018</b>	<b>2017</b>
Deferred revenue, beginning of period	\$ 16,013	\$ 16,160	\$ 17,050	\$ 17,445
Deferred revenue resulting from new contracts with customers	4,764	4,769	14,321	14,214
Deferred revenue at the beginning of the period that was amortized to revenue	(5,113)	(4,554)	(14,727)	(14,370)
Deferred revenue arising during the period that was amortized to revenue	(528)	(456)	(1,508)	(1,370)
Deferred revenue, end of period	<u>\$ 15,136</u>	<u>\$ 15,919</u>	<u>\$ 15,136</u>	<u>\$ 15,919</u>

#### Multi-Element Transactions

At the time customers purchase perpetual software licenses, they also typically purchase M&S although it is not mandatory. We do not sell separate M&S to subscribers to our SaaS solutions as M&S is provided as part of their SaaS subscription. 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 FASB Accounting Standards Codification Top 606, or 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 customers for professional services when we have fully delivered the services specified in the contract. 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 products paid to third parties. These are costs 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 the 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 the 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 September 30, 2018</b>	<b>Nine Months Ended September 30, 2018</b>
Deferred expense, beginning of period	\$ 1,172	\$ 1,240
Deferred expense resulting from new contracts with customers	149	496
Deferred expense amortized to expense	(216)	(631)
Deferred expense, end of period	<u>\$ 1,105</u>	<u>\$ 1,105</u>

At September 30, 2018, \$598,000 was recorded in prepaid and current other assets and \$507,000 was recorded in other assets in our condensed consolidated balance sheet.

The following tables present our reported results under ASC 606 and a reconciliation to results using the historical accounting method:

**GlobalSCAPE, Inc.**  
**Condensed Consolidated Balance Sheet**  
(in thousands)  
As of September 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	\$ 9,630		\$ 9,630
Certificates of deposit, short term	1,530		1,530
Accounts receivable, net	4,853	(75)	4,778
Federal income tax receivable	740	50	790
Prepaid and other current assets	3,173	(598)	2,575
Total current assets	19,926	(623)	19,303
Capitalized software development costs, net	3,384		3,384
Goodwill	12,712		12,712
Deferred tax asset, net	330	161	491
Property and equipment, net	442		442
Other assets	577	(508)	69
Total assets	<u>\$ 37,371</u>	<u>\$ (970)</u>	<u>\$ 36,401</u>
<b>Liabilities and Stockholders' Equity</b>			
Current liabilities:			
Accounts payable	1,982		1,982
Accrued expenses	3,378	(75)	3,303
Deferred revenue	12,341		12,341
Total current liabilities	17,701	(75)	17,626
Deferred revenue, non-current portion	2,795		2,795
Other long term liabilities	128		128
Stockholders' Equity:			
Preferred stock	-		-
Common stock	22		22
Additional paid-in capital	25,106		25,106
Treasury stock	(18,714)		(18,714)
Retained earnings	10,333	(895)	9,438
Total stockholders' equity	16,747	(895)	15,852
Total liabilities and stockholders' equity	<u>\$ 37,371</u>	<u>\$ (970)</u>	<u>\$ 36,401</u>

**GlobalSCAPE, Inc.**  
**Condensed Consolidated Statement of Operations and Comprehensive Income**  
(in thousands, except per share amounts)  
For the Three Months Ended September 30, 2018  
(unaudited)

	<u>As Reported</u>	<u>Effect of ASC 606</u>	<u>ASC 605 Historical</u>
Operating revenues:			
Software licenses	\$ 2,843		\$ 2,843
Maintenance and support	5,488		5,488
Professional services	649		649
Total revenues	<u>8,980</u>	<u>-</u>	<u>8,980</u>
Costs of revenues			
Software licenses	721	(28)	693
Maintenance and support	514		514
Professional services	264		264
Total costs of revenues	<u>1,499</u>	<u>(28)</u>	<u>1,471</u>
Gross Profit	<u>7,481</u>	<u>28</u>	<u>7,509</u>
Operating expenses			
Sales and marketing	2,261	(23)	2,238
General and administrative	1,589		1,589
Legal and professional	1,510		1,510
Severance	381		381
Research and development	368		368
Total operating expenses	<u>6,109</u>	<u>(23)</u>	<u>6,086</u>
Income from operations	<u>1,372</u>	<u>51</u>	<u>1,423</u>
Interest income (expense), net	<u>(93)</u>		<u>(93)</u>
Income before income taxes	<u>1,279</u>	<u>51</u>	<u>1,330</u>
Income tax expense	<u>281</u>	<u>11</u>	<u>292</u>
Net income	<u>\$ 998</u>	<u>\$ 40</u>	<u>\$ 1,038</u>
Comprehensive income	<u>\$ 998</u>	<u>\$ 40</u>	<u>\$ 1,038</u>
Net income per common share - basic	<u>\$ 0.05</u>	<u>\$ 0.00</u>	<u>\$ 0.05</u>
Net income per common share - diluted	<u>\$ 0.05</u>	<u>\$ 0.00</u>	<u>\$ 0.05</u>

**GlobalSCAPE, Inc.**  
**Condensed Consolidated Statement of Operations and Comprehensive Income**  
(in thousands, except per share amounts)  
For the Nine Months Ended September 30, 2018  
(unaudited)

	<u>As Reported</u>	<u>Effect of ASC 606</u>	<u>ASC 605 Historical</u>
Operating revenues:			
Software licenses	\$ 7,726		\$ 7,726
Maintenance and support	15,872		15,872
Professional services	1,549		1,549
Total revenues	<u>25,147</u>	<u>-</u>	<u>25,147</u>
Costs of revenues			
Software licenses	2,225	(42)	2,183
Maintenance and support	1,574		1,574
Professional services	880		880
Total costs of revenues	<u>4,679</u>	<u>(42)</u>	<u>4,637</u>
Gross Profit	<u>20,468</u>	<u>42</u>	<u>20,510</u>
Operating expenses			
Sales and marketing	8,229	(92)	8,137
General and administrative	4,883		4,883
Legal and professional	4,235		4,235
Severance	488		488
Research and development	1,654		1,654
Total operating expenses	<u>19,489</u>	<u>(92)</u>	<u>19,397</u>
Income from operations	<u>979</u>	<u>134</u>	<u>1,113</u>
Interest income (expense), net	<u>63</u>		<u>63</u>
Income before income taxes	<u>1,042</u>	<u>134</u>	<u>1,176</u>
Income tax expense	<u>386</u>	<u>50</u>	<u>436</u>
Net income	<u>\$ 656</u>	<u>\$ 84</u>	<u>\$ 740</u>
Comprehensive income	<u>\$ 656</u>	<u>\$ 84</u>	<u>\$ 740</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>

**GlobalSCAPE, Inc.**  
**Condensed Consolidated Statements of Cash Flows**  
(in thousands)  
For the Nine Months Ended September 30, 2018  
*(unaudited)*

	<u>As Reported</u>	<u>Effect of ASC 606</u>	<u>ASC 605 Historical</u>
Operating Activities:			
Net Income	\$ 656	84	\$ 740
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	1,641		1,641
Share-based compensation	972		972
Deferred taxes	61		61
Subtotal before changes in operating assets and liabilities	<u>3,266</u>	<u>84</u>	<u>3,350</u>
Changes in operating assets and liabilities:			
Accounts receivable	1,136	(75)	1,061
Prepaid and other current assets	(1,868)	(134)	(2,002)
Deferred revenues	(1,914)		(1,914)
Accounts payable	82		82
Accrued expenses	1,707	75	1,782
Other assets	116		116
Accrued interest receivable	-		-
Other long-term liabilities	(48)		(48)
Federal income tax receivable	82	50	132
Net cash provided by operating activities	<u>2,559</u>	<u>-</u>	<u>2,559</u>
Investing Activities:			
Software development costs	(1,057)		(1,057)
Purchase of property and equipment	(143)		(143)
Redemption of Certificates of Deposit	14,264		14,264
Net cash provided by investing activities	<u>13,064</u>	<u>-</u>	<u>13,064</u>
Financing Activities:			
Proceeds from exercise of stock options	341		341
Purchase of treasury stock	(17,262)		(17,262)
Dividends paid	(655)		(655)
Net cash used in financing activities	<u>(17,576)</u>	<u>-</u>	<u>(17,576)</u>
Net increase in cash	<u>(1,953)</u>		<u>(1,953)</u>
Cash at beginning of period	11,583	-	11,583
Cash at end of period	<u>\$ 9,630</u>	<u>\$ -</u>	<u>\$ 9,630</u>
Supplemental disclosure of cash flow information:			
Cash paid during the period for:			
Interest	<u>\$ -</u>		<u>\$ -</u>
Income tax payments	<u>\$ 238</u>		<u>\$ 238</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. At least annually, 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, 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 \$172,000 and \$480,000 in the 2018 quarter and the 2017 quarter, respectively, and \$750,000 and \$1,508,000 in the 2018 nine months and 2017 nine 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 primarily use 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 condensed 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.

### ***Recently Issued Accounting Pronouncements***

FASB has issued the Accounting Standard Updates, or ASU described below that we believe may be relevant to our business and to the preparation of our condensed consolidated 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 an 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 ASU 2017-04 will not have a material effect on our condensed 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 nine months of 2018, we had no transactions of the type cited in our Condensed Consolidated Statement of Cash Flows 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 2016-13 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:
  - 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 will 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 will recognize expense ratably monthly over the estimated life of the customer relationship.

We have reviewed all recently issued accounting pronouncements. The pronouncements that we have already adopted did not have a material effect on our financial condition, results of operations, cash flows or reporting thereof, and except as otherwise noted above, we do not believe that any of the pronouncements that we have not yet adopted will have a material effect upon our financial condition, results of operations, cash flows or reporting thereof.

#### 4. Certificates of Deposit

Our certificate of deposit is held at a bank and will mature in October 2018. 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 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 customers and issue invoices when we have delivered goods or services. In addition, when customers agree to purchase or renew M&S services, we bill and invoice 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 condensed 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):

	September 30, 2018	December 31, 2017
Total invoices issued and unpaid	\$ 5,324	\$ 6,644
Less: Unpaid invoices relating to M&S contracts with a start date subsequent to the balance sheet date	(371)	(441)
Gross accounts receivable	4,953	6,203
Allowance for doubtful accounts	(100)	(278)
Accounts receivable, net	<u>\$ 4,853</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>September 30,</b>		<b>December 31,</b>	
	<b>2018</b>		<b>2017</b>	
Gross capitalized cost	\$	10,235	\$	9,179
Accumulated amortization		(6,851)		(5,393)
Capitalized software development costs, net	\$	3,384	\$	3,786

  

	<b>Three Months Ended September 30,</b>		<b>Nine Months Ended September 30,</b>	
	<b>2018</b>	<b>2017</b>	<b>2018</b>	<b>2017</b>
Amount capitalized	\$ 264	\$ 527	\$ 1,057	\$ 1,464
Amortization expense	(460)	(484)	(1,459)	(1,404)

  

	<b>Released Products</b>		<b>Unreleased Products</b>	
Gross capitalized amount at September 30, 2018	\$	9,624	\$	611
Accumulated amortization		(6,851)		-
Net capitalized cost at September 30, 2018	\$	2,773	\$	611

  

Future amortization expense:		
Three months ending December 31, 2018		431
Year ending December 31,		
2019		1,367
2020		857
2021		118
Total	\$	2,773

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 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>September 30, 2018</b>	<b>December 31, 2017</b>
Total invoiced for M&S contracts for which revenue will be recognized in future periods	\$ 15,507	\$ 17,491
Less: Unpaid invoices relating to M&S contracts with a start date subsequent to the balance sheet date	(371)	(441)
Total deferred revenue	\$ 15,136	\$ 17,050

  

Deferred revenue, current portion	\$ 12,341	\$ 13,315
Deferred revenue, non-current portion	2,795	3,735
Total deferred revenue	\$ 15,136	\$ 17,050

## 8. Stock Options, Restricted Stock and Stock-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 our Board of Directors. Our stock-based compensation expense was as follows (\$ in thousands):

	<b>Three Months Ended September 30,</b>		<b>Nine Months Ended September 30,</b>	
	<b>2018</b>	<b>2017</b>	<b>2018</b>	<b>2017</b>
Share-based compensation expense	\$ 110	\$ 381	\$ 972	\$ 1,053

### *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 Employee Long-Term Equity Incentive Plan (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 our 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 September 30, 2018, stock-based incentives for up to 3,955,830 shares remained available for issuance in the future under the 2016 Plan.

We have not previously issued any restricted stock under any of the Company’s plans.

Our stock option activity has been as follows:

	<b>Number of Shares</b>	<b>Weighted Average Exercise Price Per Share</b>	<b>Weighted Average Remaining Contractual Term in Years</b>	<b>Aggregate Intrinsic Value (000's)</b>
Outstanding at December 31, 2017	2,585,210	\$ 3.34	6.77	\$ 1,015
Granted	504,737	\$ 3.67		
Forfeited	(809,142)	\$ 3.56		
Exercised	(146,150)	\$ 2.34		
Outstanding at September 30, 2018	<u>2,134,655</u>	\$ 3.40	6.59	\$ 1,413
Exercisable at September 30, 2018	<u>1,163,958</u>	\$ 3.09	4.60	\$ 1,115

Additional information about our stock options is as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2018	2017	2018	2017
Weighted average fair value of options granted	\$ 1.57	\$ 1.94	\$ 1.56	\$ 1.67
Intrinsic value of options exercised	\$ 205,111	\$ 9,284	\$ 205,111	\$ 351,893
Cash received from stock options exercised	\$ 341,489	\$ 13,440	\$ 341,489	\$ 471,789
Number of options that vested	72,748	28,570	511,900	430,724
Fair value of options that vested	\$ 139,406	\$ 44,843	\$ 861,904	\$ 698,442
Unrecognized compensation expense related to non-vested options at end of period	\$ 1,286,260	\$ 1,994,289	\$ 1,286,260	\$ 1,994,289
Weighted average years over which non-vested option expense will be recognized	2.15	2.11	2.15	2.11

Plan	Shares outstanding
2000 Stock Option Plan	25,000
2010 Employee LT Equity Incentive Plan	1,066,319
2016 Employee LT Equity Incentive Plan	1,043,336
Total shares outstanding at September 30, 2018	2,134,655

As of September 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
\$1.43 - \$2.32	289,350	2.14	\$ 1.86	289,350	\$ 1.86
\$2.34 - \$3.52	708,636	5.77	\$ 3.29	506,860	\$ 3.23
\$3.53 - \$5.30	1,135,002	8.25	\$ 3.86	366,081	\$ 3.85
\$5.44 - \$5.44	1,667	0.24	\$ 5.44	1,667	\$ 5.44
Total options	2,134,655			1,163,958	

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2018	2017	2018	2017
Expected volatility	48%	50%	48%	49%
Expected annual dividend yield	1.50%	1.50%	1.50%	1.50%
Risk free rate of return	2.80%	1.95%	2.75%	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 (the “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 our 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 September 30, 2018, stock based incentives for up to 280,000 shares remained available for issuance in the future under the 2015 Directors Plan.

## 9. Income Taxes

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

	Three months ended September 30,						Nine months ended September 30,					
	2018			2017			2018			2017		
	Current	Deferred	Total	Current	Deferred	Total	Current	Deferred	Total	Current	Deferred	Total
Federal	\$ 166	\$ 43	\$ 209	\$ 29	\$ 146	\$ 175	\$ 243	\$ 51	\$ 294	\$ 733	\$ 33	\$ 766
State	67	5	72	10	9	19	82	10	92	109	(5)	\$ 104
Total	\$ 233	\$ 48	\$ 281	\$ 39	\$ 155	\$ 194	\$ 325	\$ 61	\$ 386	\$ 842	\$ 28	\$ 870

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):

	September 30, 2018	December 31, 2017
Deferred tax assets:		
Deferred revenue	\$ 829	\$ 775
Share-based compensation	302	351
Compensation and benefits	55	111
Texas franchise tax R&D credit	189	185
Prepaid expenses not deductible for tax	-	84
Allowance for doubtful accounts	37	58
Net operating loss carryforward	5	20
Deferred state income taxes	51	61
Federal R&D credits	-	-
Accrued expenses not deducted for tax	5	9
Valuation allowance	(189)	(185)
Total deferred tax assets	1,284	1,469
Deferred tax liabilities:		
Intangible assets	721	805
Book expenses deductible for tax purposes	232	-
Depreciable Assets	1	13
Total gross deferred tax liabilities	954	818
Net deferred tax assets	\$ 330	\$ 651

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 September 30, 2018, we had federal income tax net operating loss carryforwards of \$23,000 available to offset future federal taxable income. We expect to fully utilize this net operating loss in 2018. If not used, this net operating loss expires in 2038.

As of September 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, we 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):

	Nine Months Ended September 30,	
	2018	2017
Balance at beginning of period	\$ 158	\$ 121
Increases for tax positions related to the current year	10	16
Increases for tax positions related to prior years	-	16
Decreases for tax positions where the statute has expired	(48)	-
Balance at end of period	<u>\$ 120</u>	<u>\$ 153</u>

Our unrecognized tax benefit is related to research and development credits taken on our U.S. income tax returns in 2012, 2013, 2015, 2016, and 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 September 30, 2018, no interest or penalties had been or were required to be accrued. We file income tax returns in the US and in various state jurisdictions with varying statutes of limitations. We are no longer subject to income tax examination by tax authorities for years prior to 2011 with respect to our federal income tax returns and years prior to 2013 with respect to 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 nine months and 34% for the 2017 quarter and 2017 nine months to income before income taxes as follows (\$ in thousands):

	Three months ended September 30,		Nine months ended September 30,	
	2018	2017	2018	2017
Income tax expense at federal statutory rate	\$ 269	\$ 160	\$ 219	\$ 828
Increase (decrease) in taxes resulting from:				
State taxes, net of federal benefit	58	16	89	67
Stock based compensation	14	37	164	121
Other	2	7	7	19
R&D tax credit uncertain tax position (net)	(45)	6	(38)	32
Research and development credit	(17)	(30)	(55)	(177)
Domestic production activities deduction	-	(2)	-	(20)
Income tax expense per the statements of operations	<u>\$ 281</u>	<u>\$ 194</u>	<u>\$ 386</u>	<u>\$ 870</u>

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 per Common Share

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

	<b>Three Months Ended</b>		<b>Nine Months Ended</b>	
	<b>September 30,</b>		<b>September 30,</b>	
	<b>2018</b>	<b>2017</b>	<b>2018</b>	<b>2017</b>
Numerator for basic and diluted earnings per share:				
Net income	\$ 998	\$ 276	\$ 656	\$ 1,564
<b>Denominators</b>				
Denominators for basic and diluted earnings per share:				
Weighted average shares outstanding - basic	21,688	21,792	21,746	21,672
<b>Dilutive potential common shares</b>				
Stock options and awards	252	455	298	473
Denominator for diluted earnings per share	21,940	22,247	22,044	22,145
Net income per common share - basic	\$ 0.05	\$ 0.01	\$ 0.03	\$ 0.07
Net income per common share - diluted	\$ 0.05	\$ 0.01	\$ 0.03	\$ 0.07

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 stock-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 nine months and 2017 nine months as follows:

	<b>Three Months Ended</b>				<b>September 30,</b>
	<b>March 31, 2018</b>	<b>March 31, 2017</b>	<b>June 30, 2018</b>	<b>June 30, 2017</b>	<b>2017</b>
Dividend per share of common stock	\$ 0.015	\$ 0.015	\$ 0.015	\$ 0.015	\$ 0.015
Dividend record date	March 9, 2018	February 23, 2017	June 8, 2018	May 23, 2017	August 23, 2017
Dividend payment date	March 23, 2018	March 8, 2017	June 22, 2018	June 8, 2017	September 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 approximately \$1.3 million.

## 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. The parties reached a settlement and submitted a Stipulation of Settlement to the Court on September 13, 2018. Under this settlement, the Company's and Individual Defendants' insurance carrier will provide the Class with a cash payment of \$1,400,000, which includes the cash amount of any attorney's fees or litigation expenses that the Court may award Lead Plaintiff's counsel and costs Lead Plaintiff may incur in administering and providing notice of the settlement. In exchange, Lead Plaintiff has agreed that the settlement will include a dismissal of the Class Action with prejudice and a release of all claims against the Company and the Individual Defendants by the Class. This settlement was preliminarily approved by the Court on October 2, 2018. The Court has scheduled a hearing on December 18, 2018 to determine whether an Order and Final Judgment of the settlement should be entered. The settlement will not become effective until finally approved by the Court. The Company has accrued the \$1,400,000 expense in the third quarter of 2018 and has also accrued a receivable of \$1,400,000 as this settlement will be funded by our insurance carrier.

On October 12, 2018, the Company received a letter from a stockholder demanding that the Company take action to remedy alleged harm caused to the Company, including to remedy alleged breaches of fiduciary duties by certain current and/or former directors and executive officers of the Company ("the Derivative Demand"). The stockholder alleges, *inter alia*, that certain current and former directors and executive officers violated their fiduciary duties beginning at least in July 2016, causing GlobalSCAPE to suffer damages by overstating financial results for the fourth quarter of 2016.

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, the Section 220 Demand, and the Derivative 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 12% and 14%, respectively, of our revenue from such sales through our largest third-party channel distributor. During the 2018 nine months and 2017 nine months, we earned approximately 13% and 14%, respectively, of our revenue from such sales through our largest, third-party channel distributor. As of September 30, 2018, approximately 17% 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 ASC 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 30% of our total revenues in the 2018 quarter and 2017 quarter, and 29% and 26% for the 2018 nine months and 2017 nine months, respectively. Revenue derived from customers and partners in the United Kingdom were 13% of our revenue in the 2017 quarter. Each individual foreign country accounts for less than 10% of total revenue in the 2018 quarter. 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 September 30, 2018.

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

This Quarterly Report on Form 10-Q (this "Quarterly Report"), 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, (the "Securities Act") and Section 21E of the Securities Exchange Act of 1934, as amended (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 Annual Report on Form 10-K for the fiscal year ended December 31, 2017 (the "2017 Form 10-K") and other documents filed with the Securities and Exchange Commission (the "SEC"). 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 September 30, 2018 and 2017, respectively. Our references to the 2018 nine months and the 2017 nine months refer to the nine months ended September 30, 2018 and 2017, respectively.

### Overview

GlobalSCAPE, Inc., together with its wholly-owned subsidiary (collectively referred to as the "Company", "GlobalSCAPE", "we", "us" or "our"), develops and sells 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 ("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 ("EFT") platform. This on-premise and cloud-based delivery 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. 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 ("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 ("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 for which users pay a base monthly subscription fee plus an additional variable amount 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 nine months ended September 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.

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.
  - 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 M&S contracts are renewed over successive years. 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 September 30, 2018 and 2017" and "Comparison of the Consolidated Statement of Operations for the Nine Months Ended September 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. 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 future revenue.

## ***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 United States generally accepted accounting principles (“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 condensed consolidated financial statements prepared in accordance with GAAP.

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2018	2017	2018	2017
Net Income	\$ 998	\$ 276	\$ 656	\$ 1,564
Add (subtract) items to determine Adjusted EBITDA:				
Income tax expense	281	194	386	870
Interest (income) expense, net	93	(75)	(63)	(221)
Depreciation and amortization:				
Total depreciation and amortization	522	547	1,641	1,604
Amortization of capitalized software development costs	(460)	(484)	(1,459)	(1,404)
Share-based compensation expense	110	381	972	1,053
Adjusted EBITDA	\$ 1,544	\$ 839	\$ 2,133	\$ 3,466

See “Comparison of the Consolidated Statement of Operations for the Three Months Ended September 30, 2018 and 2017” and “Comparison of the Consolidated Statement of Operations for the Nine Months Ended September 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 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 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 experienced issues with the third-party technology and suspended marketing of the product. We have settled the dispute with the third-party and have accrued a liability in these financial statements in the amount of the settlement, including any anticipated settlement fees.

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. 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.

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. 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, compliance 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, 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 also 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 provide 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, compliance and security requirements. In addition to enabling the secure, flexible transmission of critical information using servers, 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 and collaboration, and continuous data backup and recovery.

During 2017 and the 2018 nine months, 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.

#### 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.

**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.

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 generates incremental revenue for us at a relatively low cost. 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, but will not invest significantly enhancing or marketing the product.

**Professional Services**

We offer a wide range of professional services to complement our on-premises and SaaS solutions. These services can include:

- System integration and implantation
- Business process and workflow planning
- Policy development
- Education and training
- Solution health checks

**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 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 fee 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 workforce is organized as follows:

Department	September 30,	
	2018	2017
Sales and Marketing	36	56
Engineering	9	30
Professional Services	5	6
Customer Support	24	23
Management and Administration	16	19
Total	90	134

On August 3, 2018, we implemented a plan to restructure our organization, which included a reduction in workforce of approximately 40 employees, representing approximately 30% of the Company's total pre-restructuring workforce. We recorded a charge of \$381,000 in the third quarter of 2018 relating to this reduction in force, consisting primarily of one-time severance payments and termination benefits. The Company's goal in the restructuring is to better focus our workforce on retaining current customers, gaining incremental business from current customers, and winning new business in the market segments where we can leverage our expertise and long history as an EFT pioneer.

The Company expects for the realignment to result in a significant reduction in total expenses. Furthermore, to the extent that it can be successfully implemented without negatively impacting revenues or growth opportunities, the realignment offers an opportunity for the Company to realize significant increases in operating earnings in future periods, although there can be no assurance that any such increase will occur.

### Solution Perspective and Trends

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

	Three Months Ended September 30, 2018		2017		Nine Months Ended September 30, 2018		2017	
	Amount	Percent of Total	Amount	Percent of Total	Amount	Percent of Total	Amount	Percent of Total
<b>Revenue By Type</b>								
License	\$ 2,843	31.7%	\$ 2,488	30.3%	\$ 7,726	30.7%	\$ 7,768	30.9%
M&S	5,488	61.1%	5,360	65.2%	15,872	63.1%	15,702	62.5%
Professional Services	649	7.2%	368	4.5%	1,549	6.2%	1,652	6.6%
Total Revenue	<u>\$ 8,980</u>	<u>100.0%</u>	<u>\$ 8,216</u>	<u>100.0%</u>	<u>\$ 25,147</u>	<u>100.0%</u>	<u>\$ 25,122</u>	<u>100.0%</u>
<b>Revenue by Product Line</b>								
License								
EFT Platform	\$ 2,767	97.3%	\$ 2,388	96.0%	\$ 7,479	96.8%	\$ 7,338	94.5%
Other	76	2.7%	100	4.0%	247	3.2%	430	5.5%
Total License Revenue	<u>2,843</u>	<u>100.0%</u>	<u>2,488</u>	<u>100.0%</u>	<u>7,726</u>	<u>100.0%</u>	<u>7,768</u>	<u>100.0%</u>
M&S								
EFT Platform	5,270	96.0%	5,100	95.1%	15,202	95.8%	14,893	94.8%
Other	218	4.0%	260	4.9%	670	4.2%	809	5.2%
Total M&S Revenue	<u>5,488</u>	<u>100.0%</u>	<u>5,360</u>	<u>100.0%</u>	<u>15,872</u>	<u>100.0%</u>	<u>15,702</u>	<u>100.0%</u>
Professional Services (all EFT Platform)								
	<u>649</u>	<u>100.0%</u>	<u>368</u>	<u>100.0%</u>	<u>1,549</u>	<u>100.0%</u>	<u>1,652</u>	<u>100.0%</u>
Total Revenue								
EFT Platform	8,686	96.7%	7,856	95.6%	24,230	96.4%	23,883	95.1%
Other	294	3.3%	360	4.4%	917	3.6%	1,239	4.9%
Total Revenue	<u>\$ 8,980</u>	<u>100.0%</u>	<u>\$ 8,216</u>	<u>100.0%</u>	<u>\$ 25,147</u>	<u>100.0%</u>	<u>\$ 25,122</u>	<u>100.0%</u>

Revenue from our EFT platform products increased 10.6% for the 2018 quarter compared to the 2017 quarter and 1.5% for the 2018 nine months compared to the 2017 nine months. Revenue for our other product lines decreased 18.3% for the 2018 quarter compared to the 2017 quarter and 26.0% for the 2018 nine months compared to the 2017 nine 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 September 30, 2018 and 2017” and “Comparison of the Consolidated Statement of Operations for the Nine Months Ended September 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. We recognize revenue 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 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 total revenue, a migration by 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.

We have developed and offered consumer 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 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>September 30, 2018</b>	<b>December 31, 2017</b>
Cash and cash equivalents	\$ 9,630	\$ 11,583
Short term certificates of deposit	1,530	4,291
Long term certificates of deposit	-	11,503
Total cash, cash equivalents and certificates of deposit	<u>\$ 11,160</u>	<u>\$ 27,377</u>
Current assets	\$ 19,926	\$ 23,296
Current liabilities	(17,701)	(16,886)
Working capital	<u>\$ 2,225</u>	<u>\$ 6,410</u>

At September 30, 2018, our certificate of deposit in current assets matures in October 2018.

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 Nine Months Ended September 30,</b>	
	<b>2018</b>	<b>2017</b>
Operating activities	\$ 2,559	\$ 4,773
Investing activities	13,064	(1,713)
Financing activities	(17,576)	(508)

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

- Accounts receivable decreasing \$1.1 million during the 2018 nine months compared to decreasing \$1.8 million during the 2017 nine months due primarily to more cash collected from customers in the 2017 nine months as a result of increased collection activities that concentrated on older, smaller outstanding receivables, which was not necessary in 2018.

- Accounts payable increasing \$82,000 during the 2018 nine months compared to increasing \$448,000 during the 2017 nine months due to normal variations in the timing of payments to our vendors.
- Deferred revenue decreasing \$1.9 million during the 2018 nine months compared to decreasing \$1.5 million during the 2017 nine months due primarily to a decrease in multi-year renewals.
- Prepaid and other current assets increasing \$1.9 million in the 2018 nine months compared to decreasing \$163,000 in the 2017 nine months due primarily to a receivable from our insurance carrier relating to legal expense and securities class action complaint described in Footnote 12.
- Net income after considering items not involving cash at the time they are recorded in the statement of operations and comprehensive income, as set forth on our Condensed Consolidated Statements of Cash Flows, decreasing from \$4.8 million in the 2017 nine months to \$2.6 million in the 2018 nine months. “See Comparison of the Consolidated Statement of Operations for the Nine Months Ended September 30, 2018 and 2017” for a discussion of the changes in the components of these amounts.

Offset by:

- Accrued expenses increasing \$1.7 million in the 2018 nine months compared to increasing \$404,000 in the 2017 nine months due primarily to the accrual of a \$1.4 million future payment related to the settlement of the securities class action complaint described in footnote 12 and the accrual of one-time severance payments and termination costs in association with the reduction in force.
- Federal income tax receivable decreasing \$82,000 in the 2018 nine months compared to increasing \$759,000 in the 2017 nine months due primarily to paying \$1.3 million more in income tax payments in the 2017 nine months as compared to the 2018 nine months.

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

- The redemption of the majority of our certificates of deposit which caused an increase of \$14.3 million in the 2018 nine months, for which no comparable event in the 2017 nine months occurred.

Offset by:

- A decrease in the purchase of property and equipment as a result of remodeling of our sales and engineering office spaces in the 2017 nine months, for which there was no comparable event in the 2018 nine months.
- A decrease in our software development costs capitalized due to the reduction in force which significantly reduced the headcount in our engineering department.

Financing activities used more cash during the 2018 nine months than during the 2017 nine months primarily due to:

- The purchase of \$17.2 million of our common stock, predominantly through our tender offer.
- A decrease in proceeds received from the exercise of stock options during the 2018 nine months compared to the 2017 nine months as a result of a moratorium on issuing shares of common stock in 2018, which was lifted in August of 2018.

Offset by:

- No dividend payment in the third quarter of 2018 compared to a dividend payment of approximately \$328,000 in the third quarter of 2017.

## Contractual Obligations and Commitments

As of September 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 \$15.1 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.
- 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 September 30, 2018, consisted primarily of the following (\$ in thousands):

	Amounts Due for the Period				
	Three Months	Fiscal Years			
	Ending December 31, 2018	2019	2020	Thereafter	Total
Operating leases	\$ 90	\$ 120	\$ 0	\$ 0	\$ 210

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

## Comparison of the Condensed Consolidated Statement of Operations for the Three Months Ended September 30, 2018 and 2017

	Three Months Ended September 30,		\$ Change
	2018	2017	
	\$ in thousands		
Total revenues	\$ 8,980	\$ 8,216	\$ 764
Total cost of revenues	1,499	1,573	(74)
Gross profit	7,481	6,643	838
Operating expenses			
Sales and marketing	2,261	3,079	(818)
General and administrative	1,589	1,573	16
Legal and professional	1,510	1,002	508
Severance	381	-	381
Research and development	368	594	(226)
Total operating expenses	6,109	6,248	(139)
Income from operations	1,372	395	977
Other income	(93)	75	(168)
Income before income taxes	1,279	470	809
Income tax expense	281	194	87
Net income	\$ 998	\$ 276	\$ 722

In the discussion below, the percentage changes cited are based on the 2018 quarter amounts compared to the 2017 quarter amounts.

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

	Three Months Ended September 30,			
	2018		2017	
	Amount	Percent of Total	Amount	Percent of Total
<b>Revenue By Type</b>				
License	\$ 2,843	31.7%	\$ 2,488	30.3%
M&S	5,488	61.1%	5,360	65.2%
Professional Services	649	7.2%	368	4.5%
Total Revenue	<u>\$ 8,980</u>	<u>100.0%</u>	<u>\$ 8,216</u>	<u>100.0%</u>
<b>Revenue by Product Line</b>				
License				
EFT Platform	\$ 2,767	97.3%	\$ 2,388	96.0%
Other	76	2.7%	100	4.0%
	<u>2,843</u>	<u>100.0%</u>	<u>2,488</u>	<u>100.0%</u>
M&S				
EFT Platform	5,269	96.0%	5,100	95.1%
Other	219	4.0%	260	4.9%
	<u>5,488</u>	<u>100.0%</u>	<u>5,360</u>	<u>100.0%</u>
Professional Services (all EFT Platform)	<u>649</u>	<u>100.0%</u>	<u>368</u>	<u>100.0%</u>
Total Revenue				
EFT Platform	8,685	96.7%	7,856	95.6%
Other	295	3.3%	360	4.4%
	<u>\$ 8,980</u>	<u>100.0%</u>	<u>\$ 8,216</u>	<u>100.0%</u>

Our total revenue increased 9.3%. Revenue from our EFT platform products and services increased 10.6%. Revenue from our other products that consist of Mail Express, WAFS, CuteFTP, and TappIn decreased to comprising 3.3% 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 15.9%. 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.



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 3.3% 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 \$281,000 more for the 2018 quarter compared to the 2017 quarter which is an increase of 76.4%. This increase was primarily due an increase in software license sales, which typically results in higher professional service revenue.

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, 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. Customers pay 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 3.3% 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 18.1% 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, however although we do expect them to continue to produce a modest contribution margin.

**Cost of Revenues.** These expenses are associated with the production, delivery and support of our products and services. We believe it is 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 primarily consists of:

- Amortization of capitalized software development costs we incur when producing our software products. 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 0.6% and as a percent of software license revenue was 25.4% in the 2018 quarter compared to 29.1% 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 9.4% in the 2018 quarter as compared to 8.3% in the 2017 quarter. Cost of revenue for M&S in absolute dollars increased by 15.2%. 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 40.6% in the 2018 quarter as compared to 109.2% 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 34.3% due to a decrease in our professional services headcount.

**Sales and Marketing.** We believe it 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 25.2% of total revenue for the 2018 quarter compared to 37.5% of total revenue for the 2017 quarter. In absolute dollars these expenses decreased 26.6% due primarily to decreased marketing expenses related to a decrease in our spending for content syndication and reduced headcount.

**General and Administrative.** These expenses increased 1.0% primarily due to fees related to our 2018 Shareholder Meeting which was held in October of 2018, whereas our 2017 Shareholder Meeting was held in May of 2017.

**Legal and Professional.** These expenses increased 50.7% primarily 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.

**Severance.** These expenses increased \$381,000 due to the one-time severance payments and termination benefits associated with the reduction in force.

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

	Three Months Ended September 30,	
	2018	2017
R&D expenditures expensed	\$ 368	\$ 594
R&D expenditures capitalized	264	527
Total R&D expenditures (non-GAAP measurement)	\$ 632	\$ 1,121

Our total R&D expenditures decreased 43.6% during the 2018 quarter as compared with the 2017 quarter primarily due fewer employed software engineers and technical personnel.

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 has historically consisted primarily of interest income earned on certificates of deposit. In the 2018 quarter the amount is an expense due to the forfeiture of approximated \$155,000 in accrued interest. This forfeiture was the result of redeeming a long term certificate of deposit before its scheduled maturity date in order to fund the purchase of shares related to the tender offer.

**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 Condensed Consolidated Statement of Operations for the Nine Months Ended September 30, 2018 and 2017

	Nine Months Ended September 30,		
	2018	2017	\$ Change
	\$ in thousands		
Total revenues	\$ 25,147	\$ 25,122	\$ 25
Total cost of revenues	4,679	4,637	42
Gross profit	20,468	20,485	(17)
Operating expenses			
Sales and marketing	8,229	9,564	(1,335)
General and administrative	4,883	4,607	276
Legal and professional	4,235	1,550	2,685
Severance	488	21	467
Research and development	1,654	2,530	(876)
Total operating expenses	19,489	18,272	1,217
Income from operations	979	2,213	(1,234)
Other income	63	221	(158)
Income before income taxes	1,042	2,434	(1,392)
Income tax expense	386	870	(484)
Net income	\$ 656	\$ 1,564	\$ (908)

In the discussion below, the percentage changes cited are based on the 2018 nine month amounts compared to the 2017 nine month amounts.

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

	Nine Months Ended September 30,			
	2018		2017	
	Amount	Percent of Total	Amount	Percent of Total
<b>Revenue By Type</b>				
License	\$ 7,726	30.7%	\$ 7,768	30.9%
M&S	15,872	63.1%	15,702	62.5%
Professional Services	1,549	6.2%	1,652	6.6%
Total Revenue	<u>\$ 25,147</u>	<u>100.0%</u>	<u>\$ 25,122</u>	<u>100.0%</u>
<b>Revenue by Product Line</b>				
License				
EFT Platform	\$ 7,479	96.8%	\$ 7,338	94.5%
Other	247	3.2%	430	5.5%
	<u>7,726</u>	<u>100.0%</u>	<u>7,768</u>	<u>100.0%</u>
M&S				
EFT Platform	15,202	95.8%	14,893	94.8%
Other	670	4.2%	809	5.2%
	<u>15,872</u>	<u>100.0%</u>	<u>15,702</u>	<u>100.0%</u>
Professional Services (all EFT Platform)	1,549	100.0%	1,652	100.0%
Total Revenue				
EFT Platform	24,230	96.4%	23,883	95.1%
Other	917	3.6%	1,239	4.9%
	<u>\$ 25,147</u>	<u>100.0%</u>	<u>\$ 25,122</u>	<u>100.0%</u>

Our total revenue was relatively flat for the 2018 nine months as compared to the 2017 nine months. Revenue from our EFT platform products and services increased 1.5%. 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 1.9%. This increase was primarily due to an increase in the number of large transactions, including transactions that were expected to close in 2017.

M&S revenue from our EFT platform products increased 2.1% 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. 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 customers.

Professional services revenue decreased \$103,000 primarily due to a lower headcount in our professional services department which resulted in fewer resources available to deliver 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.

**Cost of Revenues.** These expenses are associated with the production, delivery and support of our products and services. We believe it is 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. 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 28.8% in the 2018 nine months and 2017 nine months. An increase in amortization of capitalized software development cost and third-party hosting fees for our SaaS products was offset by lower royalty expense.

Cost of M&S revenue as a percent of M&S revenue was 9.9% in the 2018 nine months as compared to 8.2% in the 2017 nine months. Cost of revenue for M&S in absolute dollars increased by 22.7%. 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 56.8% in the 2018 nine months as compared to 67.8% in the 2017 nine 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 21.4% due to a decrease in our professional services revenue for the reasons discussed above.

**Sales and Marketing.** We believe it 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 32.7% of total revenue for the 2018 nine months compared to 38.1% of total revenue for the 2017 nine months. In absolute dollars these expenses decreased 14.0%, due primarily to a decrease in the headcount of our sales representatives, 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.

**General and Administrative.** These expenses increased 6.0% 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 173.2% or \$2.7 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

**Severance.** These expenses increased \$467,000 due mainly to the one-time severance payments and termination benefits associated with the reduction in force.

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

	Nine Months Ended September 30,	
	2018	2017
R&D expenditures expensed	\$ 1,654	\$ 2,530
R&D expenditures capitalized	1,057	1,464
Total R&D expenditures (non-GAAP measurement)	\$ 2,711	\$ 3,994

Our total R&D expenditures decreased 32.1% primarily due to a reduction of expenses related to fewer software engineers and technical personnel.

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.** Interest income has historically consisted primarily of interest income earned on certificates of deposit. The reduction in income in 2018 is due to the forfeiture of approximated \$155,000 in accrued interest. This forfeiture was the result of redeeming a long term certificate of deposit before its scheduled maturity date in order to fund the purchase of shares relate to the tender offer.

**Income Taxes.** Our effective tax rate differed from the federal statutory tax rate of 21% for the 2018 nine months and 34% for the 2017 nine 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 nine 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 12% and 14%, 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 nine months and 2017 nine months, we earned approximately 13% and 14%, respectively, of our revenue from the same third-party channel distributor. Approximately 17% of our accounts receivable as of September 30, 2018 were due from this distributor. We have since received payment for substantially all of these accounts receivable.

We earned approximately 30% of our revenue from customers outside the United States during the 2018 and 2017 quarter, and 29% and 26% for the 2018 nine months and 2017 nine 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 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, our disclosure controls and procedures were not effective as of September 30, 2018.

As previously reported in our 2017 Form 10-K, filed with the SEC 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 September 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 began conducting 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 September 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 Quarterly Report, you should carefully consider the factors discussed in Part I, “Item 1A. Risk Factors” in our 2017 Form 10-K filed with the SEC on June 14, 2018. Except as set forth in this Quarterly Report and as provided below, the risks and uncertainties described in “Item 1A. Risk Factors” of our 2017 Form 10-K have not materially changed. These risk factors could materially affect our business, financial condition or future results, but they are not the only risks facing the Company. 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.

#### *We face risks related to an ongoing investigation by the United States Attorney’s Office for the Western District of Texas.*

On May 31, 2018, we were 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. We intend 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, we are unable to predict the duration, scope, result or related costs of the U.S. Attorney’s Investigation. We are 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.

### Item 2. Unregistered Sales of Equity Securities and Use of Proceeds.

Period	(a) Total number of shares (or units) purchased	(b) Average price paid per share (or unit)	(c) Total number of shares (or units) purchased as part of publicly accounted plans or programs	(d) Maximum number (or approximate dollar value) of shares (or units) that may yet be purchased under the plans or programs
September 1, 2018 - September 30, 2018	4,011,013	\$ 4.20	-	-
Total	4,011,013	\$ 4.20	-	-

The Company commenced on August 22, 2018 a modified dutch tender offer to purchase \$15,000,000 of shares of our common stock at a price not greater than \$4.50 nor less than \$4.00 per share, to expire on September 19, 2018. Based on the final count by American Stock Transfer & Trust Company, the Depository for the Tender Offer, the Company accepted for purchase 4,011,013 common shares at a purchase price of \$4.20 per share, for an aggregate cost of approximately \$16.8 million, excluding fees and expenses relating to the Tender Offer. Included within the shares accepted for purchase are 439,585 shares that we elected to purchase pursuant to our right to increase the size of the Tender Offer by up to 2.0% of the Company’s outstanding common stock. As such, the Company used a proration factor of approximately 77.1% of shares from each tendering stockholder. The common shares purchased represent approximately 18.2% of our common stock issued and outstanding as of September 24, 2018. Following consummation of the Tender Offer, we had 17,968,268 common shares outstanding.

**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.](#)

101 Interactive Data File.

\* Filed herewith.

**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.**

November 8, 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: November 8, 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: November 8, 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 September 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.

November 8, 2018

/s/ Matthew C. Goulet

Matthew C. Goulet  
President and Chief Executive Officer

/s/ Karen J. Young

Karen J. Young  
Chief Financial Officer