

INTELLIGENT SYSTEMS CORP
Form 10-Q
May 10, 2016

United States

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

Quarterly Report UNDER Section 13 or 15(d) of the Securities Exchange Act of 1934

For the quarterly period ended March 31, 2016

OR

Transition Report UNDER Section 13 or 15(d) of the Securities Exchange Act of 1934

For the transition period from _____ to _____

Commission file number 1-9330

INTELLIGENT SYSTEMS CORPORATION

(Exact name of registrant as specified in its charter)

Georgia

(State or other jurisdiction of incorporation or organization)

58-1964787

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

4355 Shackleford Road, Norcross, Georgia

(Address of principal executive offices)

30093

(Zip Code)

Registrant's telephone number, including area code: **(770) 381-2900**

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

Indicated by check mark whether the registrant has submitted electronically and posted on its corporate Website, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T 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 or a smaller reporting company. See the definitions of "large accelerated filer", "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer

Accelerated filer

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

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

As of April 30, 2016, 8,731,299 shares of Common Stock of the issuer were outstanding.

Intelligent Systems Corporation

Index

Form 10-Q

		<u>Page</u>
Part I	Financial Information	
Item 1	Financial Statements	
	Consolidated Balance Sheets at March 31, 2016 and December 31, 2015	3
	Consolidated Statements of Operations for the three months ended March 31, 2016 and 2015	4
	Consolidated Statements of Comprehensive Income (Loss) for the three months ended March 31, 2016 and 2015	5
	Consolidated Statements of Cash Flows for the three months ended March 31, 2016 and 2015	6
	Notes to Consolidated Financial Statements	7
Item 2	Management’s Discussion and Analysis of Financial Condition and Results of Operations	10
Item 4	Controls and Procedures	14
Part II	Other Information	
Item 6	Exhibits	14
Signatures		14
Ex. 3.1	Amended and Restated Articles of Incorporation of the Registrant dated May 4, 2011 (Incorporated by reference to Exhibit 3.(1) to the Registrant’s Form 10-Q for the period ended March 31, 2011).	
Ex. 3.2	Bylaws of the Registrant dated December 7, 2007. (Incorporated by reference to Exhibit 3.2 of the Registrant’s Form 8-K dated December 7, 2007).	
Ex. 31.1	Section 302 Certification of Chief Executive Officer	
Ex. 31.2	Section 302 Certification of Chief Financial Officer	
Ex. 32.1	Section 906 Certification of Chief Executive Officer and Chief Financial Officer	
Ex.101.INS**	XBRL Instance	
Ex.101.SCH**	XBRL Taxonomy Extension Schema	

Ex.101.CAL** XBRL Taxonomy Extension Calculation
Ex 101.DEF** XBRL Taxonomy Extension Definitions
Ex.101.LAB** XBRL Taxonomy Extension Labels
Ex.101.PRE** XBRL Taxonomy Extension Presentation

XBRL information is furnished and not filed or a part of a registration statement or prospectus for purposes of **sections 11 or 12 of the Securities Act of 1933, as amended, is deemed not filed for purposes of section 18 of the Securities Exchange Act of 1934, as amended, and otherwise is not subject to liability under these sections.

Part I Financial Information**Item 1. Financial Statements****Intelligent Systems Corporation****CONSOLIDATED BALANCE SHEETS***(in thousands, except share and per share amounts)*

As of	March 31, 2016	December 31, 2015
	(unaudited)	(audited)
ASSETS		
Current assets:		
Cash	\$ 16,868	\$ 18,059
Marketable securities	405	396
Accounts receivable, net	965	962
Other current assets	824	2,846
Restricted cash	2,200	2,200
Total current assets	21,262	24,463
Investments	308	1,015
Property and equipment, at cost less accumulated depreciation	672	636
Other long-term assets	44	59
Total assets	\$ 22,286	\$ 26,173
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	\$ 191	\$ 78
Deferred revenue, current portion	1,974	1,830
Accrued payroll	589	495
Accrued expenses	35	25
Other current liabilities	275	243
Liabilities from discontinued operations	--	120
Total current liabilities	3,064	2,791
Deferred revenue, net of current portion	105	195
Other long-term liabilities	18	18
Intelligent Systems Corporation stockholders' equity:		
Common stock, \$0.01 par value, 20,000,000 shares authorized, 8,731,299 issued and outstanding at March 31, 2016 and December 31, 2015	87	87
Additional paid-in capital	17,824	20,875
Accumulated other comprehensive loss	(178)	(184)
Retained earnings	4,333	5,270
Total Intelligent Systems Corporation stockholders' equity	22,066	26,048

Edgar Filing: INTELLIGENT SYSTEMS CORP - Form 10-Q

Noncontrolling interest	(2,967)	(2,879)
Total stockholders' equity	19,099	23,169
Total liabilities and stockholders' equity	\$ 22,286	\$ 26,173

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

Intelligent Systems Corporation**CONSOLIDATED STATEMENTS OF OPERATIONS***(unaudited, in thousands, except share and per share amounts)*

	Three Months Ended March 31,	
	2016	2015
Revenue		
Products	\$230	\$136
Services	1,417	933
Total net revenue	1,647	1,069
Cost of revenue		
Products	64	59
Services	647	547
Total cost of revenue	711	606
Expenses		
Marketing	96	71
General and administrative	556	367
Research and development	645	694
Loss from operations	(361)	(669)
Other income (loss)	(664)	2
Loss from continuing operations before income taxes	(1,025)	(667)
Income taxes	(1)	3
Loss from continuing operations	(1,024)	(670)
Gain on sale of discontinued operations, net of taxes	--	18,746
Loss from discontinued operations, net of taxes	--	(3)
Net income (loss)	(1,024)	18,073
Net loss attributable to noncontrolling interest	87	223
Net income (loss) attributable to Intelligent Systems Corporation	\$(937)	\$18,296
Earnings (loss) per share attributable to Intelligent Systems Corporation:		
Basic		
Continuing operations	\$(0.11)	\$(0.05)
Discontinued operations	--	2.09
Earnings (loss) per share	\$(0.11)	\$2.04
Diluted		
Continuing operations	\$(0.11)	\$(0.05)
Discontinued operations	--	2.08
Earnings (loss) per share	\$(0.11)	\$2.03
Basic weighted average common shares outstanding	8,731,299	8,958,028
Diluted weighted average common shares outstanding	8,731,299	9,029,273
Net income (loss) attributable to Intelligent Systems Corporation:		
Loss from continuing operations	\$(937)	\$(447)
Income from discontinued operations	--	18,743
Net income (loss) attributable to Intelligent Systems Corporation	\$(937)	\$18,296

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

Page 4

Intelligent Systems Corporation

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)

(unaudited, in thousands)

	Three Months Ended March 31,	
	2016	2015
Net income (loss)	\$(1,024)	\$18,073
Other comprehensive income (loss):		
Foreign currency translation adjustments	(4)	(4)
Unrealized gain on available-for-sale marketable securities	10	2
Total comprehensive income (loss)	(1,018)	18,071
Comprehensive loss attributable to noncontrolling interest	87	222
Comprehensive income (loss) attributable to Intelligent Systems Corporation	\$(931)	\$18,293

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

Intelligent Systems Corporation

CONSOLIDATED STATEMENTS OF CASH FLOWS*(unaudited, in thousands)*

CASH PROVIDED BY (USED FOR):	Three Months Ended March 31,	
	2016	2015
OPERATING ACTIVITIES:		
Net income (loss)	\$(1,024)	\$18,073
Income from discontinued operations	--	(18,743)
Net loss from continuing operations	(1,024)	(670)
Adjustments to reconcile net loss from continuing operations to net cash used for operating activities:		
Depreciation and amortization	59	36
Stock-based compensation expense	5	4
Non-cash investment expense	700	--
Equity in (income) loss of affiliate company	6	6
Changes in operating assets and liabilities:		
Accounts receivable	(2)	53
Other current assets	(225)	128
Other long term assets	15	3
Accounts payable	113	36
Accrued payroll	94	(63)
Deferred revenue, current portion	144	(3)
Accrued expenses	10	7
Other current liabilities	32	--
Deferred revenue, net of current portion	(90)	34
Other long-term liabilities	--	(18)
Net cash used for operating activities	(163)	(447)
INVESTING ACTIVITIES:		
Purchases of property and equipment	(95)	(10)
Proceeds from sale of long term investment	2,248	--
Purchase of long-term investment	--	(30)
Net cash used for investing activities	2,153	(40)
FINANCING Activities:		
Distribution of dividend to stockholders	(3,056)	--
Net cash used for financing activities	(3,056)	--
Net cash provided by (used for) operating activities from discontinued operations	(120)	415
Net cash provided by investing activities from discontinued operations	--	18,202
Net cash provided by (used for) discontinued operations	(120)	18,617

Edgar Filing: INTELLIGENT SYSTEMS CORP - Form 10-Q

Effects of exchange rate changes on cash	(5)	(4)
Net increase (decrease) in cash	(1,191)	18,126
Cash at beginning of period	18,059	2,624
Cash at end of period	\$16,868	\$20,750

SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:

Cash paid during the period for income taxes	\$120	\$--
--	-------	------

The accompanying notes are an integral part of these Consolidated Financial Statements.

Intelligent Systems Corporation**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****(unaudited)**

Throughout this report, the terms “we”, “us”, “ours”, “ISC” and “company” refer to Intelligent Systems Corporation, including its wholly-owned and majority-owned subsidiaries. The unaudited Consolidated Financial Statements presented in this Form 10-Q have been prepared in accordance with accounting principles generally accepted in the United States applicable to interim financial statements. Accordingly, they do not include all of the information and notes required for complete financial statements. In the opinion of ISC management, these Consolidated Financial Statements contain all adjustments (which comprise only normal and recurring accruals) necessary to present fairly the financial position and results of operations as of and for the three month periods ended March 31, 2016 and 2015. The interim results for the three months ended March 31, 2016 are not necessarily indicative of the results to be expected for the full year. These statements should be read in conjunction with our Consolidated Financial Statements and notes thereto for the fiscal year ended December 31, 2015, as filed in our Annual Report on Form 10-K.

Sale of Subsidiary; Discontinued Operations – On March 31, 2015, we and CRC Industries, Inc., a Pennsylvania corporation (“CRC”), entered into a Stock Purchase Agreement (the “Stock Purchase Agreement”) whereby we sold all of the issued and outstanding stock of our wholly owned subsidiary, ChemFree Corporation (“ChemFree”), to CRC (the “ChemFree Sale”). The purchase price for the all-cash sale was \$21,600,000, subject to customary post-closing adjustments, including a working capital adjustment. The company retained all net cash of ChemFree as of the closing date. In the quarter ended March 31, 2015, the company recorded a gain on the sale of ChemFree of \$18,746,000 and retroactively classified the ChemFree operations as discontinued operations in all periods presented. The company is applying operating loss and capital loss carryforwards against the gain on sale and expects to incur an alternative minimum tax liability of approximately \$120,000 on the transaction, which amount is included in liabilities of discontinued operations as of December 31, 2015 and was paid in the quarter ended March 31, 2016. At the closing, a total of \$3,300,000 of the purchase price was placed in escrow for purposes of securing our obligations to indemnify CRC and to refund a portion of the purchase price if ChemFree’s actual working capital amount on the closing date is less than the agreed upon target set forth in the Stock Purchase Agreement. In 2015, \$880,000 of the escrow amount, net of the final working capital adjustment of \$220,000 was released to the company. The remaining escrow balance of \$2,200,000, which will remain in escrow until September 30, 2016, is shown as Restricted Cash as of December 31, 2015 and March 31, 2016.

The following condensed financial information is provided for the ChemFree discontinued operations for the periods shown:

(unaudited, in thousands)

**Three
Months
Ended
March 31,
20162015**

Edgar Filing: INTELLIGENT SYSTEMS CORP - Form 10-Q

Net sales	\$--	\$2,902
Operating loss	--	(3)
Net income (loss) before income taxes	--	6
Income taxes	--	9
Net loss from discontinued operations	\$--	\$(3)

The only liabilities of discontinued operations, presented separately on the balance sheet as of December 31, 2015, consist of \$120,000 in current tax liabilities, which were paid before March 31, 2016.

Investment Write-down – In the quarter ended March 31, 2016, we recorded an impairment charge of \$700,000 to reduce the carrying value of our minority equity ownership in Lumense, Inc., an early stage sensor technology 3. company, to \$50,000. Given Lumense’s limited funding to support its operation and product development, we are not comfortable assigning a higher realizable value to our investment in Lumense at this point and therefore believe an impairment charge is prudent and required.

Stock-based Compensation – At March 31, 2016, we have three stock-based compensation plans in effect. We record compensation cost related to unvested stock awards by recognizing the unamortized grant date fair value on a straight line basis over the vesting periods of each award. We have estimated forfeiture rates based on our historical 4. experience. Stock option compensation expense for the three month periods ended March 31, 2016 and 2015 has been recognized as a component of general and administrative expenses in the accompanying Consolidated Financial Statements. We recorded \$5,000 and \$4,000 of stock-based compensation expense in the quarters ended March 31, 2016 and 2015, respectively.

As of March 31, 2016, there is \$18,000 of unrecognized compensation cost related to stock options. No options were granted during the three months ended March 31, 2016. The following table summarizes options as of March 31, 2016:

	# of Shares	Wgt Avg Exercise Price	Wgt Avg Remaining Contractual Life in Years	Aggregate Intrinsic Value
Outstanding at March 31, 2016	274,500	\$ 1.76	5.3	\$ 465,390
Vested and exercisable at March 31, 2016	254,500	\$ 1.72	5.0	\$ 443,030

The estimated fair value of options granted is calculated using the Black-Scholes option pricing model with assumptions as previously disclosed in our 2015 Form 10-K.

The aggregate intrinsic value in the table above represents the total pre-tax intrinsic value (the difference between the company's closing stock price on the last trading day of the first quarter of 2016 and the exercise price, multiplied by the number of in-the-money options) that would have been received by the option holders had all option holders exercised their options on March 31, 2016. The amount of aggregate intrinsic value will change based on the market value of the company's stock.

Fair Value of Financial Instruments – The carrying value of cash, marketable securities, accounts receivable, accounts payable and certain other financial instruments (such as short-term borrowings, accrued expenses, and other current liabilities) included in the accompanying consolidated balance sheets approximates their fair value principally due to the short-term maturity of these instruments.

Financial instruments that potentially subject us to concentrations of credit risk consist principally of cash, marketable securities and trade accounts. Our available cash is held in accounts managed by third-party financial institutions. Cash may exceed the Federal Deposit Insurance Corporation, or FDIC, insurance limits. While we monitor cash balances on a regular basis and adjust the balances as appropriate, these balances could be impacted if the underlying financial institutions fail. To date, we have experienced no loss or lack of access to our cash; however, we can provide no assurances that access to our cash will not be impacted by adverse conditions in the financial markets.

6. *Fair Value Measurements* – In determining fair value, the company uses quoted market prices in active markets. GAAP establishes a fair value measurement framework, provides a single definition of fair value, and requires

expanded disclosure summarizing fair value measurements. GAAP emphasizes that fair value is a market-based measurement, not an entity specific measurement. Therefore, a fair value measurement should be determined based on the assumptions that market participants would use in pricing an asset or liability.

GAAP establishes a hierarchy for inputs used in measuring fair value that maximizes the use of observable inputs and minimizes the use of unobservable inputs by requiring that the most observable input be used when available. Observable inputs are based on data obtained from sources independent of the company that market participants would use in pricing the asset or liability. Unobservable inputs are inputs that reflect the company's assumptions about the estimates market participants would use in pricing the asset or liability developed based on the best information available in the circumstances.

The hierarchy is measured in three levels based on the reliability of inputs:

- Level 1

Valuations based on quoted prices in active markets for identical assets or liabilities that we have the ability to access. Valuation adjustments and block discounts are not applied to Level 1 instruments.

- Level 2

Valuations based on quoted prices in less active, dealer or broker markets. Fair values are primarily obtained from third party pricing services for identical or comparable assets or liabilities.

• Level 3

Valuations derived from other valuation methodologies, including pricing models, discounted cash flow models and similar techniques, and not based on market, exchange, dealer, or broker-traded transactions. Level 3 valuations incorporate certain assumptions and projections that are not observable in the market and significant professional judgment is needed in determining the fair value assigned to such assets or liabilities.

In instances where the determination of the fair value measurement is based on inputs from different levels of the fair value hierarchy, the level in the fair value hierarchy within which the entire fair value measurement falls is based on the lowest level input that is significant to the fair value measurement in its entirety.

Our available-for-sale investments are classified within Level 1 of the valuation hierarchy.

The fair value of equity method and cost method investments has not been determined as it was impracticable to do so due to the fact that the investee companies are relatively small, early stage private companies for which there is no comparable valuation data available without unreasonable time and expense.

Concentration of Revenue – The following table indicates the percentage of consolidated revenue represented by each customer that represented more than 10 percent of consolidated revenue in the three month period ended March 31. Most of our customers have multi-year contracts with recurring revenue as well as professional services fees that vary by period depending on their business needs.

	Three Months Ended March 31, 2016 2015	
Customer A	23.1 %	22.4 %
Customer B	6.8 %	12.0 %
Customer C	9.4 %	23.2 %
Customer D	14.7 %	0.0 %

Commitments and Contingencies – Please refer to Note 8 to our Consolidated Financial Statements included in our 2015 Form 10-K for a description of our commitments and contingencies. In the ordinary course of business, from time to time we may be involved in various pending or threatened legal actions. The litigation process is inherently uncertain and it is possible that the resolution of such matters might have a material adverse effect upon our financial condition and/or results of operations.

Income Taxes – We recognize deferred tax liabilities and assets for the expected future tax consequences of events that have been included in the financial statements or tax returns. Deferred tax liabilities and assets are determined based on the difference between the financial statement and tax bases of assets and liabilities using enacted tax rates in effect for the year in which the differences are expected to reverse. Deferred tax assets are recognized, net of a valuation allowance, for the estimated future tax effects of deductible temporary differences and tax credit carry-forwards. A valuation allowance against deferred tax assets is recorded when, and if, based upon available evidence, it is more likely than not that some or all deferred tax assets will not be realized.

There were no unrecognized tax benefits at March 31, 2016 and December 31, 2015. Our policy is to recognize interest and penalties accrued on any unrecognized tax benefits as a component of income tax expense. There were no accrued interest or penalties associated with any unrecognized tax benefits, nor was any interest expense recognized during the periods presented. We have determined we have no uncertain tax positions.

We file a consolidated U.S. federal income tax return for all subsidiaries in which our ownership equals or exceeds 80%, as well as individual subsidiary returns in various states and foreign jurisdictions. With few exceptions we are no longer subject to U.S. federal, state and local or foreign income tax examinations by taxing authorities for years before 2012.

Recent Accounting Pronouncements – In February 2016, the FASB issued ASU 2016-02 – Leases (Topic 842) related to the accounting for leases. This pronouncement requires lessees to record most leases on their balance sheet, while expense recognition on the income statement remains similar to current lease accounting guidance. The guidance also eliminates real estate-specific provisions and modifies certain aspects of lessor accounting. Under the new guidance, lease classification as either a finance lease or an operating lease will determine how lease-related revenue and expense are recognized. The pronouncement is effective for fiscal years, and for interim periods within those fiscal years, beginning after December 15, 2018. We are currently evaluating the effect on our consolidated financial statements.

In March 2016, the FASB issued ASU 2016-08 – Revenue from Contracts with Customers (Topic 606) related to reporting revenue gross versus net, or principal versus agent considerations. This pronouncement is meant to clarify the guidance in FASB ASU 2014-09, Revenue from Contracts with Customers, as it pertains to principal versus agent considerations. Specifically, the guidance addresses how entities should identify goods and services being provided to a customer, the unit of account for a principal versus agent assessment, how to evaluate whether a good or service is controlled before being transferred to a customer, and how to assess whether an entity controls services performed by another party. The pronouncement has the same effective date as the new revenue standard, which is effective for fiscal years, and for interim periods within those fiscal years, beginning after December 15, 2017. We are currently evaluating the effect on our consolidated financial statements.

In March 2016, the FASB issued ASU 2016-09 – Compensations – Stock Compensation (Topic 718) related to simplifications of employee share-based payment accounting. This pronouncement eliminates the APIC pool concept and requires that excess tax benefits and tax deficiencies be recorded in the income statement when awards are settled. The pronouncement also addresses simplifications related to statement of cash flows classification, accounting for forfeitures, and minimum statutory tax withholding requirements. The pronouncement is effective for fiscal years, and for interim periods within those fiscal years, beginning after December 15, 2016. We are currently evaluating the effect on our consolidated financial statements.

In April 2016, the FASB issued ASU 2016-10 – Revenue from Contract with Customers (Topic 606) related to identifying performance obligations and licensing. This pronouncement is meant to clarify the guidance in FASB ASU 2014-09, Revenue from Contracts with Customers. Specifically, the guidance addresses an entity’s identification of its performance obligations in a contract, as well as an entity’s evaluation of the nature of its promise to grant a license of intellectual property and whether or not that revenue is recognized over time or at a point in time. The pronouncement has the same effective date as the new revenue standard, which is effective for fiscal years, and for interim periods within those fiscal years, beginning after December 15, 2017. We are currently evaluating the effect on our consolidated financial statements.

We have considered all other recently issued accounting pronouncements and do not believe the adoption of such pronouncements will have a material impact on our Consolidated Financial Statements.

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

In addition to historical information, this Form 10-Q may contain forward-looking statements relating to ISC. All statements, trend analyses and other information relative to markets for our products and trends in revenue, gross margins and anticipated expense levels, as well as other statements including words such as “anticipate”, “believe”, “plan”, “estimate”, “expect”, and “intend”, and other similar expressions, constitute forward-looking statements.

Prospective investors are cautioned that any such forward-looking statements are not guarantees of future performance and involve risks and uncertainties including those factors described below under “Factors That May Affect Future Operations”, and that actual results may differ materially from those contemplated by such forward-looking statements. ISC undertakes no obligation to update or revise forward-looking statements to reflect changed assumptions, the occurrence of unanticipated events or changes in future operating results.

For purposes of this discussion and analysis, we are assuming and relying upon the reader’s familiarity with the information contained in Item 7. Management’s Discussion and Analysis of Financial Condition and Results of Operations, in the Form 10-K for the year ended December 31, 2015 as filed with the Securities and Exchange Commission.

Overview

The results reported reflect the effect of the sale of ChemFree subsidiary on March 31, 2015, as explained in more detail in Note 2 to the Consolidated Financial Statements. Our consolidated continuing operations consist of our CoreCard Software subsidiary and its affiliate companies in Romania and India, as well as the corporate office which provides significant administrative, human resources and executive management support to CoreCard.

We provide technology solutions and processing services to the financial services market, commonly referred to as the FinTech industry. We derive our product revenue from licensing our comprehensive suite of financial transaction management software to accounts receivable businesses, financial institutions, retailers and processors to manage their credit and debit cards, prepaid cards, private label cards, fleet cards, loyalty programs, and accounts receivable and small loan transactions. Our service revenue consists of fees for software maintenance and support for licensed software products, fees for processing services that we provide to companies that outsource their financial transaction processing functions to us, and professional services primarily for software customizations provided to both license and processing customers.

We have frequently recognized consolidated operating losses on a quarterly and annual basis and are likely to do so in the foreseeable future. We may report operating profits on an irregular basis and our results vary in part depending on the size and number of software licenses recognized in a particular period and the level of expenses incurred to support existing customers and development and sales activities. A significant portion of our expense is related to personnel, including approximately 240 employees located in India and Romania. In addition, we offer processing services as an alternative for customers who prefer to outsource this function instead of licensing our software and running the application in-house. We are likely to incur losses in the near future because revenue for processing services is spread out over multi-year contracts while we are currently investing in the infrastructure, resources, processes and software features to support this developing business. In addition, we have certain corporate office expenses associated with being a public company that impact our operating results.

Our revenue fluctuates from period to period and our results are not necessarily indicative of the results to be expected in future periods. It is difficult to predict the level of consolidated revenue on a quarterly or annual basis for a number of reasons, including the following:

Software license revenue in a given period may consist of a relatively small number of contracts and contract values can vary considerably depending on the software product and scope of the license sold. Consequently, even minor delays in delivery under a software contract (which may be out of our control) could have a significant and unpredictable impact on the consolidated revenue that we recognize in a given quarterly or annual period.

Customers may decide to postpone or cancel a planned implementation of our software for any number of reasons, which may be unrelated to our software or contract performance, but which may affect the amount, timing and characterization of our deferred and/or recognized revenue.

Customers typically require our professional services to modify or enhance their CoreCard software implementation based on their specific business strategy and operational requirements, which vary from customer to customer and period to period.

The timing of new processing customer implementations is often dependent on third party approvals or processes which are typically not under our direct control.

Results of Operations

The following discussion should be read in conjunction with the Consolidated Financial Statements and the notes to Consolidated Financial Statements presented in this quarterly report. The results for 2015 reflect the former ChemFree subsidiary as a discontinued operation.

Revenue – Total revenue from continuing operations in the three month period ended March 31, 2016 was \$1,647,000, fifty-four percent greater than total revenue in the first quarter of 2015.

Revenue from products, which includes software license fees (and, in some cases monthly support fees when the license and support fees are bundled) was \$230,000 in the three month period ended March 31, 2016, compared to

\$136,000 in the three months ended March 31, 2015. The increase reflects growth in the number of accounts covered by certain software licenses.

Revenue from services was \$1,417,000 in the first quarter of 2016 compared to \$933,000 in the first quarter of 2015. Revenue from transaction processing services, maintenance technical and software support services, and professional services were greater in the first quarter of 2016 as compared to the first quarter of 2015 due to an increase in the number of customers and accounts on file and more revenue was generated from professional services due to an increase in the number and value of professional services contracts completed during the first quarter of 2016. We expect that processing services will continue to grow as our customer base increases; however, the time required to implement new customer programs has proven longer than anticipated due to delays in third party integration and approval processes. It is not possible to predict with any accuracy the number and value of professional services contracts that our customers will require in a given period. Customers typically request our professional services to modify or enhance their CoreCard® software implementation based on their specific business strategy and operational requirements, which vary from customer to customer and period to period.

Cost of Revenue – Total cost of revenue was 43 percent and 57 percent of total revenue in the three month period ended March 31, 2016 and 2015, respectively.

Cost of product revenue as a percent of product revenue was 28 percent and 43 percent in the periods ended March 31, 2016 and 2015, respectively but essentially the same absolute dollar cost in both periods. The lower cost as a percentage of product revenue is related to the fact that a component of the 2016 revenue is from license tier upgrade fees, which have lower direct cost than other license revenue.

Cost of service revenue as a percentage of total service revenue was 46 percent in the first quarter of 2016 compared to 59 percent in the first quarter of 2015. Cost of service revenue includes three components: costs to provide annual maintenance and support services to our installed base of licensed customers, costs to provide professional services, and costs to provide our financial transaction processing services. The cost and gross margins on such services vary considerably depending on the customer mix, customer requirements and project complexity as well as the mix of our U.S. and offshore employees working on the various aspects of services provided. In addition, we continue to devote the resources necessary to support our developing processing business, including direct costs for regulatory compliance, infrastructure, network certifications, and customer support. Although we are starting to achieve economies of scale, we still expect these costs to continue to outpace processing revenue for the foreseeable future.

Operating Expenses – In the three month period ended March 31, 2016, total operating expenses from continuing operations were fifteen percent greater than in the comparable period in 2015. Marketing expenses were higher by \$25,000 due to a focus on new marketing initiatives for CoreCard in 2016. General and Administrative expenses were higher by \$189,000 in the first quarter of 2016. In the first quarter of 2015 a significant component of corporate G&A expenses was charged to our former ChemFree subsidiary for services provided by the corporate office to ChemFree and is included in the line item Income from Discontinued Operations. Following the sale of ChemFree in March 2015, corporate activities and resources (and the associated expense) have been re-