AGILYSYS INC
Form 10-Q
January 26, 2018
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

(Mark One)

x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended December 31, 2017
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 0-5734

AGILYSYS, INC.
(Exact name of registrant as specified in its charter)

Ohio	34-0907152
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

1000 Winward Concourse, Suite 250, Alpharetta, Georgia	30005
(Address of principal executive offices)	(ZIP Code)

(770) 810-7800

(Registrant's telephone
number, including
area code)

N/A
(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 x No ¨

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x 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 x
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 x

The number of Common Shares of the registrant outstanding as of January 22, 2018 was 23,313,156.

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AGILYSYS, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS
(Unaudited)

(In thousands, except share data)	December 31, 2017	March 31, 2017
ASSETS		
Current assets:		
Cash and cash equivalents	$ 37,615	$49,255
Accounts receivable, net of allowance for doubtful accounts of $751 and $509, respectively	14,746	15,598
Inventories	2,131	2,211
Prepaid expenses and other current assets	6,849	6,456
Total current assets	61,341	73,520
Property and equipment, net	17,760	16,000
Goodwill	19,622	19,622
Intangible assets, net	8,496	8,530
Software development costs, net	46,086	46,999
Other non-current assets	2,613	2,634
Total assets	$ 155,918	$167,305
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$ 8,175	$8,702
Deferred revenue	23,433	29,183
Accrued liabilities	9,843	8,331
Capital lease obligations, current	113	121
Total current liabilities	41,564	46,337
Deferred income taxes, non-current	2,105	3,181
Capital lease obligations, non-current	50	116
Other non-current liabilities	3,985	4,002
Commitments and contingencies (see Note 6)		
Shareholders' equity:		
Common shares, without par value, at $0.30 stated value; 80,000,000 shares authorized; 31,606,831 shares issued; and 23,402,512 and 23,210,682 shares outstanding at December 31, 2017 and March 31, 2017, respectively	9,482	9,482
Treasury shares, 8,204,319 and 8,396,149 at December 31, 2017 and March 31, 2017, respectively	(2,463)	(2,519)
Capital in excess of stated value	(2,418)	(5,782)
Retained earnings	103,812	112,692
Accumulated other comprehensive loss	(199)	(204)
Total shareholders' equity	108,214	113,669
Total liabilities and shareholders' equity	$ 155,918	$167,305

See accompanying notes to condensed consolidated financial statements.

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AGILYSYS, INC.
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(Unaudited)

	Three months ended December 31,		Nine months ended December 31,	
(In thousands, except share data)	2017	2016	2017	2016
Net revenue:				
Products	$8,156	$10,006	$25,758	$30,257
Support, maintenance and subscription services	17,215	16,234	50,990	47,087
Professional services	5,939	7,208	18,557	19,732
Total net revenue	31,310	33,448	95,305	97,076
Cost of goods sold:				
Products (inclusive of developed technology amortization)	6,820	7,530	19,862	22,217
Support, maintenance and subscription services	4,132	4,464	12,610	12,714
Professional services	4,730	5,213	15,160	13,835
Total cost of goods sold	15,682	17,207	47,632	48,766
Gross profit	15,628	16,241	47,673	48,310
	49.9 %	48.6 %	50.0 %	49.8 %
Operating expenses:				
Product development	7,269	6,847	20,708	20,647
Sales and marketing	4,278	5,000	13,616	15,746
General and administrative	6,114	3,678	18,475	13,692
Depreciation of fixed assets	581	598	1,892	1,791
Amortization of intangibles	471	353	1,421	1,031
Restructuring, severance and other charges	378	1,394	1,241	1,484
Legal settlements	150	—	150	85
Operating loss	(3,613)	(1,629)	(9,830)	(6,166)
Other (income) expense:				
Interest income	(13)	(86)	(64)	(135)
Interest expense	3	3	7	11
Other expense, net	(46)	62	(196)	140
Loss before taxes	(3,557)	(1,608)	(9,577)	(6,182)
Income tax (benefit) expense	(1,623)	129	(1,439)	252
Net loss	$(1,934)	$(1,737)	$(8,138)	$(6,434)
Weighted average shares outstanding	22,851	22,611	22,777	22,605
Loss per share - basic and diluted:				
Loss per share	$(0.08)	$(0.08)	$(0.36)	$(0.28)

See accompanying notes to condensed consolidated financial statements.

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AGILYSYS, INC.
CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE LOSS
(Unaudited)

	Three months ended December 31,		Nine months ended December 31,	
(In thousands)	2017	2016	2017	2016
Net loss	$(1,934)	$(1,737)	$(8,138)	$(6,434)
Other comprehensive gain/(loss), net of tax:				
Unrealized foreign currency translation adjustments	(17)	(5)	5	(12)
Total comprehensive loss	$(1,951)	$(1,742)	$(8,133)	$(6,446)

See accompanying notes to condensed consolidated financial statements.

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AGILYSYS, INC.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)

(In thousands)	Nine months ended December 31, 2017	2016
Operating activities		
Net loss	$(8,138)	$(6,434)
Adjustments to reconcile net loss to net cash used in operating activities		
Net restructuring, severance and other charges	262	819
Net legal settlements	150	(100)
Loss on disposal of property & equipment	—	5
Depreciation	1,892	1,791
Amortization	1,421	1,031
Amortization of developed technology	7,371	5,705
Deferred income taxes	(1,214)	105
Share-based compensation	3,776	782
Change in cash surrender value of company owned life insurance policies	11	—
Changes in operating assets and liabilities:		
Accounts receivable	903	6,668
Inventories	87	597
Prepaid expense and other current assets	460	1,306
Accounts payable	5	714
Deferred revenue	(5,787)	(4,601)
Accrued liabilities	1,681	(2,558)
Income taxes payable	(503)	104
Other changes, net	(279)	(541)
Net cash provided by operating activities	2,098	5,393
Investing activities		
Capital expenditures	(5,289)	(3,327)
Capitalized software development costs	(7,272)	(9,174)
Investments in corporate-owned life insurance policies	(27)	(1)
Net cash used in investing activities	(12,588)	(12,502)
Financing activities		
Payments to settle contingent consideration arising from business acquisition	—	(197)
Repurchase of common shares to satisfy employee tax withholding	(1,190)	(404)
Principal payments under long-term obligations	(92)	(86)
Net cash used in financing activities	(1,282)	(687)
Effect of exchange rate changes on cash	132	(99)
Net decrease in cash and cash equivalents	(11,640)	(7,895)
Cash and cash equivalents at beginning of period	$49,255	$60,608
Cash and cash equivalents at end of period	$37,615	$52,713
SUPPLEMENTAL SCHEDULE OF NON-CASH INVESTING ACTIVITIES:		
Accrued capital expenditures	$81	$293
Accrued capitalized software development costs	107	684

See accompanying notes to condensed consolidated financial statements.

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AGILYSYS, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)
(Table amounts in thousands, except per share data)

1. Nature of Operations and Financial Statement Presentation

Nature of Operations

Agilysys is a leading technology company that provides innovative software and services for point-of-sale (POS), reservation and table management, property management (PMS), inventory and procurement, workforce management, analytics, document management, and mobile and wireless solutions exclusively to the hospitality industry. Our products and services allow operators to streamline operations, improve efficiency and understand customer needs across their properties to deliver a superior overall guest experience. The result is improved guest loyalty, growth in wallet share and increased revenue as they connect and transact with their guests based upon a single integrated view of individual preferences and interactions. We serve four major market sectors: Gaming, both corporate and tribal; Hotels, Resorts and Cruise; Corporate Foodservice Management; and Restaurants, Universities, Stadia and Healthcare. A significant portion of our consolidated revenue is derived from contract support, maintenance and subscription services.

Agilysys operates across North America, Europe, Asia-Pacific, and India with headquarters located in Alpharetta, GA. For more information, visit www.agilysys.com.

Basis of Presentation

The accompanying unaudited Condensed Consolidated Financial Statements include our accounts consolidated with our wholly-owned subsidiaries. All significant intercompany accounts and transactions have been eliminated in consolidation. Our fiscal year ends on March 31st. References to a particular year refer to the fiscal year ending in March of that year. For example, fiscal 2018 refers to the fiscal year ending March 31, 2018.

Our unaudited interim financial statements are prepared in accordance with U.S. generally accepted accounting principles (GAAP) for interim financial information, the instructions to the Quarterly Report on Form 10-Q (Quarterly Report) under the Securities Exchange Act of 1934, as amended (the Exchange Act), and Rule 10-01 of Regulation S-X under the Exchange Act. Certain information and footnote disclosures normally included in the annual financial statements prepared in accordance with GAAP have been condensed or omitted pursuant to such rules and regulations relating to interim financial statements.

The Condensed Consolidated Balance Sheets as of December 31, 2017 and 2016, as well as the Condensed Consolidated Statements of Operations, Condensed Consolidated Statements of Comprehensive Loss, and the Condensed Consolidated Statements of Cash Flow for the three and nine months ended December 31, 2017 and 2016, are unaudited. However, these financial statements have been prepared on the same basis as those in the audited annual financial statements. In the opinion of management, all adjustments of a recurring nature necessary to fairly state the results of operations, financial position, and cash flows have been made.

These unaudited interim financial statements should be read together with the consolidated financial statements and related notes included in our Annual Report on Form 10-K for the year ended March 31, 2017, filed with the Securities and Exchange Commission (SEC) on June 2, 2017.

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2. Summary of Significant Accounting Policies
A detailed description of our significant accounting policies can be found in the audited financial statements for the fiscal year ended March 31, 2017, included in our Annual Report on Form 10-K. Our accounting policy for share-based compensation changed with the adoption of Accounting Standards Update ("ASU") No. 2016-09, as described further below. There have been no other material changes to our significant accounting policies and estimates from those disclosed therein.

Reclassification - Certain prior year balances have been reclassified to conform to the current year presentation. Specifically, we reclassified certain software development costs to property and equipment during the year ended March 31, 2017, which impacted the Condensed Consolidated Statement of Cash Flows for the nine months ended December 31, 2016 in the amount of $1.1 million.

Adopted and Recently Issued Accounting Pronouncements

In January 2017, the Financial Accounting Standards Board ("FASB") issued ASU No. 2017-01, Business Combinations (Topic 805): Clarifying the Definition of a Business, and ASU No. 2017-04, Intangibles- Goodwill and Other (Topic 350) - Simplifying the Test for Goodwill Impairment. ASU No. 2017-01 clarifies the definition of a business with the objective of adding guidance to assist entities with evaluating whether transactions should be accounted for as acquisitions (or disposals) of assets or businesses. The definition of a business affects many areas of accounting including acquisitions, disposals, goodwill, and consolidation. The guidance is effective for annual periods beginning after December 15, 2017, including interim periods within those periods. ASU No. 2017-04 eliminates Step 2 of the goodwill impairment test and requires a goodwill impairment to be measured as the amount by which a reporting unit’s carrying amount exceeds its fair value, not to exceed the carrying amount of its goodwill. The ASU is effective for annual or any interim goodwill impairment tests in fiscal years beginning after December 15, 2019. While we are still assessing the impact of this standard, we do not believe that the adoption of this guidance will have a material impact on our consolidated financial statements.

In October 2016, the FASB issued ASU No. 2016-16, Income Taxes (Topic 740): Intra-Entity Transfers of Assets Other Than Inventory, which requires entities to recognize the income tax consequences of an intra-entity transfer of an asset other than inventory when the transfer occurs. The new guidance is effective for annual reporting periods beginning after December 15, 2017. Early adoption is permitted as of the beginning of an annual reporting period. The new standard must be adopted using a modified retrospective transition method, with the cumulative effect recognized as of the date of initial adoption. We do not believe that the adoption of this guidance will have a material impact on our consolidated financial statements.

In March 2016, the FASB issued ASU No. 2016-09, Compensation-Stock Compensation (Topic 718), which amends the accounting for stock-based compensation. The guidance requires excess tax benefits and deficiencies to be recognized as a component of income tax expense rather than of stockholders’ equity and also allows an entity to make an accounting policy election to either estimate expected forfeitures or to account for them as they occur. ASU No. 2016-09 is effective for annual reporting periods beginning after December 15, 2016. The Company adopted the ASU in the quarter ended June 30, 2017, which is the first quarter for our annual period beginning April 1, 2017. The following summarizes the effects of the adoption on the Company's unaudited condensed consolidated financial statements:

Income taxes - In the first quarter of 2018, we did not recognize the discrete benefit related to $4.4 million of tax deductions in excess of recorded windfall tax benefits associated with stock-based compensation due to the Company’s full valuation allowance on its U.S. federal net operating losses.

Forfeitures - Prior to adoption, the Company recognized share-based compensation expense net of estimated forfeitures based on a rate management updated at least annually to reflect expected forfeitures over the vesting period. Upon adoption, the Company will no longer apply a forfeiture rate and instead will account for forfeitures as they occur. The Company applied the modified retrospective adoption approach and recorded a cumulative-effect adjustment of approximately $0.7 million to opening retained earnings. Prior periods have not been adjusted.

In February 2016, the FASB issued ASU No. 2016-02, Leases (Topic 842), which will require lessees to recognize assets and liabilities for leases with lease terms of more than 12 months. Consistent with current GAAP, the recognition, measurement, and presentation of expenses and cash flows arising from a lease by a lessee primarily will depend on its classification as a finance or operating lease. However, unlike current GAAP, which requires only capital leases to be recognized on the balance sheet, the new guidance will require both types of leases to be recognized on the balance sheet. The new guidance is effective for all periods beginning after December 15, 2018 and we are currently evaluating the effects that the adoption of ASU No. 2016-02 will have on our consolidated financial statements, but anticipate that the new guidance will materially impact our consolidated financial statements given the significance of our leases.

In May 2014, the FASB issued ASU No. 2014-09, Revenue from Contracts with Customers (Topic 606). ASU No. 2014-09 supersedes the revenue recognition requirements in Topic 605, Revenue Recognition, and most industry-specific revenue recognition guidance throughout the Industry Topics of the Accounting Standards Codification. Additionally, this update supersedes some cost guidance included in Subtopic 605-35, Revenue Recognition-Construction-Type and Production-Type Contracts. The core principle of the guidance is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. As originally issued, this guidance was effective for interim and annual reporting periods beginning after December 15, 2016, and early adoption was not permitted. In July 2015, the FASB deferred the effective date by one year, to interim and annual reporting periods beginning after December 15, 2017. The standard allows entities to apply the standard retrospectively to each prior reporting period presented (“full retrospective adoption”) or retrospectively with the cumulative effect of initially applying the standard recognized at the date of initial application (“modified retrospective adoption”). We plan to adopt ASU No. 2014-09 on its effective date for us beginning April 1, 2018 and we are still evaluating both options and their effect on our financial statements and business.

We expect to identify similar performance obligations under Topic 606 as compared with deliverables and separate units of account previously identified. As a result, we expect the timing of our revenue to occur in similar periods but we are still evaluating this theory especially with respect to multiple service contracts. We are assessing the new standard’s requirement to apply a single method to measure progress towards satisfaction of performance obligations recognized over time in our contracts that contain multiple services. We are evaluating our multiple service contracts to determine if the services are a single performance obligation under this new standard requiring a single method of measurement. We are assessing the new standards requirement to allocate the transaction prices of our contracts based on the relative stand-alone selling price of each our performance obligations. We are evaluating the stand-alone selling prices for our performance obligations. We are also assessing the new standard’s requirement to capitalize costs associated with obtaining customer contracts, including commission payments, which are currently expensed as incurred for all commissions earned subsequent to the year ended March 31, 2016. We are evaluating the period over which to amortize these capitalized costs and the applicability of the practical expediency exception which permits the continuation of expensing these costs for amortization periods of one year or less. In addition, for sales transactions that have been billed, but for which the recognition of revenue has been deferred and the related account receivable has not been collected, we currently do not recognize deferred revenue or the related accounts receivable on our consolidated balance sheet. Under the new standard, we will record accounts receivable and related contract liabilities for non-cancelable contracts with customers when the right to consideration is unconditional, which we currently expect will result in increases in accounts receivable and contract liabilities (currently presented as deferred revenue) on our consolidated balance sheet, compared to our current presentation. We are continuing to review the impacts of adopting ASU No. 2014-09 to our consolidated financial statements and these preliminary assessments of the impacts to our consolidated financial statements are subject to change. We expect to conclude our assessments of the impacts of adoption sometime during our fourth quarter ending March 31, 2018.

Management continually evaluates the potential impact, if any, of all recent accounting pronouncements on our consolidated financial statements or related disclosures and, if significant, makes the appropriate disclosures required by such new accounting pronouncements.

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3. Restructuring Charges

We recognize restructuring charges when a plan that materially changes the scope of our business or the manner in which that business is conducted is adopted and communicated to the impacted parties, and the expenses have been incurred or are reasonably estimable.

Fiscal 2018 Restructuring Activity

Q3 - In the third quarter of fiscal 2018, we recorded $0.2 million in restructuring charges related to our ongoing efforts to better allocate resources to our crucial revenue growth areas while increasing internal efficiencies in other non-revenue generating areas.

As of December 31, 2017, we had a remaining liability of approximately $0.2 million recorded for the Q3 fiscal 2018 restructuring activity.

Following is a reconciliation of the beginning and ending balances of the restructuring liability:

(in thousands)	Balance at March 31, 2017	Provision/ Adjustments	Payments	Balance at December 31, 2017
Fiscal 2018 Restructuring Plan:				
Restructuring and other employment costs	$ —	$ 1,024	$ (821)	$ 203
Total restructuring costs	$ —	$ 1,024	$ (821)	$ 203

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4. Intangible Assets and Software Development Costs

The following table summarizes our intangible assets and software development costs:

(In thousands)	December 31, 2017 Gross carrying amount	Accumulated amortization	Net carrying amount	March 31, 2017 Gross carrying amount	Accumulated amortization	Net carrying amount
Amortized intangible assets:						
Customer relationships	$10,775	$ (10,775)	$—	$10,775	$ (10,775)	$—
Non-competition agreements	2,700	(2,700)	—	2,700	(2,700)	—
Developed technology	10,055	(10,055)	—	10,055	(10,055)	—
Trade names	230	(134)	96	230	(100)	130
Patented technology	80	(80)	—	80	(80)	—
	23,840	(23,744)	96	23,840	(23,710)	130
Unamortized intangible assets:						
Trade names	8,400	N/A	8,400	8,400	N/A	8,400
Total intangible assets	$32,240	$ (23,744)	$8,496	$32,240	$ (23,710)	$8,530
Software development costs	$53,368	$ (17,727)	$35,641	$46,598	$ (10,356)	$36,242
Project expenditures not yet in use	10,445	—	10,445	10,757	—	10,757
Total software development costs	$63,813	$ (17,727)	$46,086	$57,355	$ (10,356)	$46,999

The following table summarizes our remaining estimated amortization expense relating to in service intangible assets and software development costs.

(In thousands)	Estimated Amortization Expense
Fiscal year ending March 31,	
2018	$ 2,657
2019	10,504
2020	9,765
2021	9,680
2022	2,568
2023	563
Total	$ 35,737

Amortization expense for software development costs related to assets to be sold, leased, or otherwise marketed was $2.6 million and $2.3 million for the three months ended December 31, 2017 and 2016, and $7.3 million and $5.7 million for the nine months ended December 31, 2017 and 2016, respectively. These charges are included as Products cost of goods sold within the Condensed Consolidated Statements of Operations.

Amortization expense relating to other definite-lived intangible assets was $11,500 for the three months ended December 31, 2017 and 2016, and $34,500 for the nine months ended December 31, 2017 and 2016. These charges are classified as Amortization of intangibles within the Condensed Consolidated Statements of Operations along with Amortization expense related to our Capitalized Internal-Use Software that we classify in Property and Equipment, net within the Consolidated Balance Sheets.

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Capitalized software development costs for software internally developed to be sold, leased, or otherwise marketed, are carried on our balance sheet at net carrying value, net of accumulated amortization. We capitalized approximately $1.6 million and $3.0 million during the three months ended December 31, 2017 and 2016, and $6.5 million and $8.9 million during the nine months ended December 31, 2017 and 2016, respectively.

5. Additional Balance Sheet Information

Additional information related to the Condensed Consolidated Balance Sheets is as follows:

(In thousands)	December 31, 2017	March 31, 2017
Accrued liabilities:		
Salaries, wages, and related benefits	$ 7,352	$ 6,473
Other taxes payable	819	750
Accrued legal settlements	150	—
Restructuring liabilities	203	—
Severance liabilities	16	11
Professional fees	510	221
Deferred rent	420	433
Other	373	443
Total	$ 9,843	$ 8,331
Other non-current liabilities:		
Uncertain tax positions	$ 1,508	$ 1,479
Deferred rent	2,399	2,444
Other	78	79
Total	$ 3,985	$ 4,002

Accounts Receivable, net

Accounts receivable, net of allowance for doubtful accounts was $14.7 million and $15.6 million as of December 31, 2017 and March 31, 2017, respectively. The related allowance for doubtful accounts was $0.8 million and $0.5 million as of December 31, 2017 and March 31, 2017, respectively.

In January of 2015, Caesars Entertainment Operating Company, Inc. and certain of its affiliates (Caesars) entered bankruptcy under Chapter 11 of the U.S. Bankruptcy Code. We filed a proof of claim with the Bankruptcy Court identifying approximately $0.7 million of pre-petition claims. Caesars emerged from bankruptcy in October 2017. As of December 31, 2017, we have collected on all of the $0.7 million of pre-petition claims that were outstanding.

6. Income Taxes

The following table compares our income tax (benefit) expense and effective tax rates for the three and six months ended December 31, 2017 and 2016:

	Three months ended		Nine months ended	
	December 31,		December 31,	
(Dollars in thousands)	2017	2016	2017	2016
Income tax (benefit) expense	$(1,623)	$129	$(1,439)	$252
Effective tax rate	45.6 %	(8.0)%	15.0 %	(4.1)%

For the three and nine months ended December 31, 2017, the effective tax rate was different than the statutory rate due primarily to a $1.3 million benefit resulting from the effect of a reduction in the deferred rate due to federal tax reform,

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recognition of net operating losses as deferred tax assets, which were offset by increases in the valuation allowance, certain foreign and state tax effects including a benefit of $0.4 million related to a settlement with the California Franchise Tax Board and other U.S. permanent book to tax differences.

For the three and nine months ended December 31, 2016, the effective tax rate was different than the statutory rate due primarily to the recognition of net operating losses as deferred tax assets, which were offset by increases in the valuation allowance, certain foreign and state tax effects, and other U.S. permanent book to tax differences.

We have recorded a valuation allowance offsetting substantially all of our deferred tax assets. The ultimate realization of deferred tax assets depends on the generation of future taxable income during the periods in which those temporary differences are deductible. Because of our losses in prior periods, management believes that it is more-likely-than-not that we will not realize the benefits of these deductible differences.

On December 22, 2017, the President of the United States of America signed into law the Tax Cuts and Jobs Act (the "Tax Act"). The Tax Act contains significant changes to corporate taxes, including a permanent reduction of the corporate tax rate from 35% to 21% effective January 1, 2018. The reduction in the corporate rate requires a one-time revaluation of certain tax-related assets and liabilities. As a result of the revaluation of our deferred tax assets and liabilities at December 31, 2017, we recorded a one-time tax benefit of approximately $1.3 million. This tax benefit was primarily the result of applying new lower income tax rates to the Company’s net long term deferred tax liabilities recorded on its condensed consolidated balance sheet, which are not netted with deferred tax assets or subject to the valuation allowance.

7. Commitments and Contingencies

Agilysys is the subject of various threatened or pending legal actions and contingencies in the normal course of conducting its business. We provide for costs related to these matters when a loss is probable and the amount can be reasonably estimated. The effect of the outcome of these matters on our future results of operations and liquidity cannot be predicted because any such effect depends on future results of operations and the amount or timing of the resolution of such matters. While it is not possible to predict with certainty, management believes that the ultimate resolution of such individual or aggregated matters will not have a material adverse effect on our consolidated financial position, results of operations, or cash flows.

On April 6, 2012, Ameranth, Inc. filed a complaint against us for patent infringement in the United States District Court for the Southern District of California. The complaint alleges, among other things, that point-of-sale and property management and other hospitality information technology products, software, components and/or systems sold by us infringe patents owned by Ameranth purporting to cover generation and synchronization of menus, including restaurant menus, event tickets, and other products across fixed, wireless and/or internet platforms as well as synchronization of hospitality information and hospitality software applications across fixed, wireless and internet platforms. The complaint seeks monetary damages, injunctive relief, costs and attorneys' fees. At this time, we are not able to predict the outcome of this lawsuit, or any possible monetary exposure associated with the lawsuit. However, we dispute the allegations of wrongdoing and are vigorously defending ourselves in this matter.

8. Loss per Share

The following data shows the amounts used in computing loss per share and the effect on earnings and the weighted average number of shares of dilutive potential common shares.

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(In thousands, except per share data)	Three months ended December 31, 2017	2016	Nine months ended December 31, 2017	2016
Numerator:				
Net loss	$(1,934)	$(1,737)	$(8,138)	$(6,434)
Denominator:				
Weighted average shares outstanding	22,851	22,611	22,777	22,605
Loss per share - basic and diluted:				
Loss per share	$(0.08)	$(0.08)	$(0.36)	$(0.28)
Anti-dilutive stock options, SSARs, restricted shares and performance shares	1,658	1,471	1,705	1,399

Basic earnings (loss) per share is computed as net income available to common shareholders divided by the weighted average basic shares outstanding. The outstanding shares used to calculate the weighted average basic shares excludes 530,138 and 595,625 of restricted shares at December 31, 2017 and 2016, respectively, as these shares were issued but were not vested and, therefore, not considered outstanding for purposes of computing basic (loss) earnings per share at the balance sheet dates.

Diluted earnings (loss) per share includes the effect of all potentially dilutive securities on earnings per share. We have stock options, stock-settled appreciation rights ("SSARs"), unvested restricted shares and unvested performance shares that are potentially dilutive securities. When a loss is reported, the denominator of diluted earnings per share cannot be adjusted for the dilutive impact of share-based compensation awards because doing so would be anti-dilutive. Therefore, for all periods presented, basic weighted-average shares outstanding were used in calculating the diluted net loss per share.

9. Share-based Compensation

We may grant non-qualified stock options, incentive stock options, SSARs, restricted shares, and restricted share units under our shareholder-approved 2016 Stock Incentive Plan (the 2016 Plan) for up to 2.0 million common shares, plus 957,575 common shares, the number of shares that were remaining for grant under the 2011 Stock Incentive Plan (the 2011 Plan) as of the effective date of the 2016 Plan, plus the number of shares remaining for grant under the 2011 Plan that are forfeited, settled in cash, canceled or expired. The maximum aggregate number of restricted shares or restricted share units that may be granted under the 2016 Plan is 1.25 million. With respect to awards that are intended to qualify for the performance-based exception to the deductibility limitations of Section 162(m) of the Internal Revenue Code, the maximum number of shares subject to stock options or SSARs that may be granted to an individual in a calendar year is 800,000 shares, and the maximum number of shares subject to restricted shares or restricted share units that may be granted to an individual in a calendar year is 400,000 shares.

We have a shareholder-approved 2006 Stock Incentive Plan (the 2006 Plan) that still has vested awards outstanding. Awards are no longer being granted from this incentive plan.

We may distribute authorized but unissued shares or treasury shares to satisfy share option and appreciation right exercises or restricted share and performance share awards.

We record compensation expense related to stock options, SSARs, restricted shares, and performance shares granted to certain employees and non-employee directors based on the fair value of the awards on the grant date. The fair value of restricted share and performance share awards is based on the closing price of our common shares on the grant date. The fair value of stock option and SSARs awards is estimated on the grant date using the Black-Scholes-Merton option pricing

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model, which includes assumptions regarding the risk-free interest rate, dividend yield, life of the award, and the volatility of our common shares.

The following table summarizes the share-based compensation expense for options, SSARs, restricted and performance awards included in the Condensed Consolidated Statements of Operations:

	Three months ended December 31,		Nine months ended December 31,	
(In thousands)	2017	2016	2017	2016
Product development	$456	$498	$982	$826
Sales and marketing	173	124	529	177
General and administrative	829	(680)	2,265	(221)
Total share-based compensation expense	1,458	(58)	3,776	782

Stock-Settled Stock Appreciation Rights

SSARs are rights granted to an employee to receive value equal to the difference in the price of our common shares on the date of the grant and on the date of exercise. This value is settled in common shares of Agilysys.

The following table summarizes the activity during the nine months ended December 31, 2017 for SSARs awarded under the 2011 and 2016 Plans:

(In thousands, except share and per share data)	Number of Rights	Weighted-Average Exercise Price (per right)	Remaining Contractual Term (in years)	Aggregate Intrinsic Value
Outstanding at April 1, 2017	1,094,978	$ 10.44		
Granted	204,213	10.56		
Exercised	(41,691)	9.14		
Forfeited	(55,530)	9.98		
Cancelled/expired	(54,679)	9.56		
Outstanding at December 31, 2017	1,147,291	$ 10.58	5.4	$ 2,038
Exercisable at December 31, 2017	245,064	$ 10.26	3.4	$ 574

As of December 31, 2017, total unrecognized stock based compensation expense related to non-vested SSARs was $1.2 million, which is expected to be recognized over a weighted-average vesting period of 2.0 years.

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Restricted Shares

We granted shares to certain of our Directors, executives and key employees, the vesting of which is service-based. The following table summarizes the activity during the nine months ended December 31, 2017 for restricted shares awarded under the 2016 and 2011 Plans:

(In thousands, except share and per share data)	Number of Shares	Weighted-Average Grant-Date Fair Value (per share)
Outstanding at April 1, 2017	490,355	$ 10.72
Granted	251,010	11.02
Vested	(221,897)	11.29
Forfeited	(80,793)	10.72
Outstanding at December 31, 2017	438,675	$ 10.60

The weighted-average grant date fair value of the restricted shares is determined based upon the closing price of our common shares on the grant date. As of December 31, 2017, total unrecognized stock based compensation expense related to non-vested restricted stock was $2.7 million, which is expected to be recognized over a weighted-average vesting period of 1.9 years.

Performance Shares

We awarded certain restricted shares to our Chief Executive Officer, the vesting of which is performance based. The number of shares that vest will be based on the stock price and relative attainment of performance metric, and any unvested shares will forfeit upon settlement of the bonus.

The following table summarizes the activity during the nine months ended December 31, 2017 for the performance shares awarded under the 2016 Plan:

	Number of Shares
Outstanding at April 1, 2017	—
Granted	91,463
Vested	—
Outstanding at December 31, 2017	91,463

Based on the performance goals, management estimates a liability of $225,000 to be settled through the vesting of a variable number of the performance shares subsequent to March 31, 2018. As of December 31, 2017, total unrecognized stock based compensation expense related to non-vested performance shares was $67,500, which is expected to be recognized over the remaining vesting period of 3 months.

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10. Fair Value Measurements

We estimate the fair value of financial instruments using available market information and generally accepted valuation methodologies. We assess the inputs used to measure fair value using a three-tier hierarchy. The hierarchy indicates the extent to which pricing inputs used in measuring fair value are observable in the market. Level 1 inputs include unadjusted quoted prices for identical assets or liabilities and are the most observable. Level 2 inputs include unadjusted quoted prices for similar assets and liabilities that are either directly or indirectly observable, or other observable inputs such as interest rates, foreign currency exchange rates, commodity rates, and yield curves. Level 3 inputs are not observable in the market and include our own judgments about the assumptions market participants would use in pricing the asset or liability. The use of observable and unobservable inputs is reflected in the hierarchy assessment disclosed in the tables below.

There were no significant transfers between Levels 1, 2, and 3 during the nine months ended December 31, 2017 and 2016.

The following tables present information about our financial assets and liabilities measured at fair value on a recurring basis and indicate the fair value hierarchy of the valuation techniques utilized to determine such fair value:

	Fair value measurement used			
	Recorded value as of	Active markets for identical assets or liabilities	Quoted prices in similar instruments and observable inputs	Active markets for unobservable inputs
(In thousands)	December 31, 2017	(Level 1)	(Level 2)	(Level 3)
Assets:				
Corporate-owned life insurance — non-current	$825	—	—	$ 825

	Fair value measurement used			
	Recorded value as of	Active markets for identical assets or liabilities	Quoted prices in similar instruments and observable inputs	Active markets for unobservable inputs
(In thousands)	March 31, 2017	(Level 1)	(Level 2)	(Level 3)
Assets:				
Corporate-owned life insurance — non-current	$809	—	—	$ 809

The recorded value of the corporate-owned life insurance policies is adjusted to the cash surrender value of the policies obtained from the third party life insurance providers, which are not observable in the market, and therefore, are classified within Level 3 of the fair value hierarchy. Changes in the cash surrender value of these policies are recorded within “Other expenses (income), net” in the Condensed Consolidated Statements of Operations.

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The following table presents a summary of changes in the fair value of the Level 3 assets:

(In thousands)	Nine months ended December 31, 2017	2016
Corporate-owned life insurance:		
Balance on April 1	$809	$3,122
Unrealized gain relating to instruments held at reporting date	(11)	16
Purchases, sales, issuances and settlements, net	27	1
Balance on December 31	$825	$3,139

The following tables present a summary of changes in the fair value of the Level 3 liabilities:

(In thousands)	Nine months ended December 31, 2017	2016
Contingent consideration		
Balance on April 1	$—	$197
Activity, payments and other charges (net)	—	(197)
Balance on December 31	$—	$—

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

In “Management’s Discussion and Analysis of Financial Condition and Results of Operations” (“MD&A”), management explains the general financial condition and results of operations for Agilysys and subsidiaries including:

— what factors affect our business;
— what our earnings and costs were;
— why those earnings and costs were different from the year before;
— where the earnings came from;
— how our financial condition was affected; and
— where the cash will come from to fund future operations.

The MD&A analyzes changes in specific line items in the Condensed Consolidated Statements of Operations and Condensed Consolidated Statements of Cash Flows and provides information that management believes is important to assessing and understanding our consolidated financial condition and results of operations. This Quarterly Report on Form 10-Q updates information included in our Annual Report on Form 10-K for the fiscal year ended March 31, 2017, filed with the Securities and Exchange Commission (SEC). This discussion should be read in conjunction with the Condensed Consolidated Financial Statements and related Notes that appear in Item 1 of this Quarterly Report as well as our Annual Report for the year ended March 31, 2017. Information provided in the MD&A may include forward-looking statements that involve risks and uncertainties. Many factors could cause actual results to be materially different from those contained in the forward-looking statements. See “Forward-Looking Information” on page 30 of this Quarterly Report, Item 1A "Risk Factors" in Part II of this Quarterly Report, and Item 1A “Risk Factors” in Part I of our Annual Report for the fiscal year ended March 31, 2017 for additional information concerning these items. Management believes that this information, discussion, and disclosure is important in making decisions about investing in Agilysys.

Overview

Agilysys is a leading technology company that provides innovative software and services for point-of-sale (POS), reservation and table management, property management (PMS), inventory and procurement, workforce management, analytics, document management, and mobile and wireless solutions exclusively to the hospitality industry. Our products and services allow operators to streamline operations, improve efficiency and understand customer needs across their properties to deliver a superior overall guest experience. The result is improved guest loyalty, growth in wallet share and increased revenue as they connect and transact with their guests based upon a single integrated view of individual preferences and interactions. We serve four major market sectors: Gaming, both corporate and tribal; Hotels, Resorts and Cruise; Corporate Foodservice Management; and Restaurants, Universities, Stadia and Healthcare. A significant portion of our consolidated revenue is derived from contract support, maintenance and subscription services.

Agilysys operates across North America, Europe, Asia-Pacific, and India with headquarters located in Alpharetta, GA. For more information, visit www.agilysys.com.

Our top priority is to increase shareholder value by improving operating and financial performance and profitably growing the business through superior products and services. To that end, we expect to invest a certain portion of our cash on hand to fund enhancements to existing software products, to develop and market new software products, and to expand our customer breadth, both vertically and geographically.

Our strategic plan specifically focuses on:

- Putting the customer first
- Accelerating our product development
- Improving organizational efficiency and teamwork
- Developing our employees and leaders
- Growing revenue by improving the breadth and depth of our product set across both our well established products and our newer rGuest platform
- Growing revenue through international expansion

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The primary objective of our ongoing strategic planning process is to create shareholder value by capitalizing on growth opportunities, turning profitable and strengthening our competitive position within the specific technology solutions and end markets we serve. Profitability and industry leading growth will be achieved through tighter management of operating expenses and sharpening the focus of our investments to concentrate on growth opportunities that offer the highest returns.

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Revenue - Defined

As required by the SEC, we separately present revenue earned as products revenue, support, maintenance and subscription services revenue or professional services revenue in our Condensed Consolidated Statements of Operations. In addition to the SEC requirements, we may, at times, also refer to revenue as defined below. The terminology, definitions, and applications of terms we use to describe our revenue may be different from those used by other companies and caution should be used when comparing these financial measures to those of other companies. We use the following terms to describe revenue:

- Revenue – We present revenue net of sales returns and allowances.
- Products revenue – Revenue earned from the sales of hardware equipment and proprietary and remarketed software.
- Support, maintenance and subscription services revenue – Revenue earned from the sale of proprietary and remarketed ongoing support, maintenance and subscription or hosting services.
- Professional services revenue – Revenue earned from the delivery of implementation, integration and installation services for proprietary and remarketed products.

Results of Operations

Third Fiscal Quarter 2018 Compared to Third Fiscal Quarter 2017

Net Revenue and Operating Loss

The following table presents our consolidated revenue and operating results for the three months ended December 31, 2017 and 2016:

	Three months ended December 31,		Increase (decrease)	
(Dollars in thousands)	2017	2016	$	%
Net revenue:				
Products	$8,156	$10,006	$(1,850)	(18.5)%
Support, maintenance and subscription services	17,215	16,234	981	6.0
Professional services	5,939	7,208	(1,269)	(17.6)
Total net revenue	31,310	33,448	(2,138)	(6.4)
Cost of goods sold:				
Products (inclusive of developed technology amortization)	6,820	7,530	(710)	(9.4)
Support, maintenance and subscription services	4,132	4,464	(332)	(7.4)
Professional services	4,730	5,213	(483)	(9.3)
Total cost of goods sold	15,682	17,207	(1,525)	(8.9)
Gross profit	15,628	16,241	(613)	(3.8)
Gross profit margin	49.9 %	48.6 %		
Operating expenses:				
Product development	7,269	6,847	422	6.2
Sales and marketing	4,278	5,000	(722)	(14.4)
General and administrative	6,114	3,678	2,436	66.2
Depreciation of fixed assets	581	598	(17)	(2.8)
Amortization of intangibles	471	353	118	33.4
Restructuring, severance and other charges	378	1,394	(1,016)	nm
Legal settlements	150	—	150	nm
Operating loss	$(3,613)	$(1,629)	$(1,984)	121.8 %

Operating loss percentage	(11.5)%	(4.9)%

nm - not meaningful

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The following table presents the percentage relationship of our Condensed Consolidated Statement of Operations line items to our consolidated net revenues for the periods presented:

	Three months ended December 31,	
	2017	2016
Net revenue:		
Products	26.0 %	30.0 %
Support, maintenance and subscription services	55.0	48.5
Professional services	19.0	21.5
Total	100.0 %	100.0 %
Cost of goods sold:		
Products (inclusive of developed technology amortization)	21.8 %	22.5 %
Support, maintenance and subscription services	13.2	13.3
Professional services	15.1	15.6
Total	50.1 %	51.4 %
Gross profit	49.9 %	48.6 %
Operating expenses:		
Product development	23.2 %	20.5 %
Sales and marketing	13.7	14.9
General and administrative	19.5	11.0
Depreciation of fixed assets	1.9	1.8
Amortization of intangibles	1.5	1.1
Restructuring, severance and other charges	1.2	4.2
Legal settlements	0.5	—
Operating loss	(11.5)%	(4.9)%

Net revenue. Total net revenue decreased $2.1 million, or 6.4%, during the third quarter of fiscal 2018 compared to the third quarter of fiscal 2017. Products revenue decreased $1.9 million, or 18.5%, due primarily to decreased hardware sales. Support, maintenance and subscription services revenue increased $1.0 million, or 6.0%, compared to the third quarter of fiscal 2017 driven mostly by subscription based service revenue, which increased approximately 26.2% during the third quarter of fiscal 2018 compared to the third quarter of fiscal 2017. Professional services revenue decreased $1.3 million, or 17.6%, as a result of $1.1 million in services revenue recognized in Q3 of fiscal 2017 for services provided in quarters prior to that, where contractual commitments precluded revenue recognition until that quarter and $0.2 million due to timing of customer installation and implementation projects.

Gross profit and gross profit margin. Our total gross profit decreased $0.6 million, or 3.8%, for the third quarter of fiscal 2018 and total gross profit margin increased 1.3% to 49.9% from 48.6%. Products gross profit decreased $1.1 million and gross profit margin decreased 8.3% to 16.4% primarily as a result of lower product revenue coupled with higher amortization of developed technology by $0.3 million, related to the previously announced general availability of the latest version of our rGuest Buy point of sale solution and the $6.8 million of related software development costs that was placed into service in September of 2017. Support, maintenance and subscription services gross profit increased $1.3 million and gross margin increased 3.5% to 76.0% due to the scalable nature of our infrastructure supporting and hosting customers. Professional services gross profit decreased $0.8 million and gross profit margin decreased 7.3% to 20.4% due to lower quarterly professional services revenues on a higher cost structure following a recent alignment toward enabling the Company to provide more customer-centric services going forward.

Operating expenses

Operating expenses, excluding the charges for asset write-offs and other fair value adjustments, legal settlements, and restructuring, severance and other charges, increased $2.2 million, or 13.6%, during the third quarter of fiscal 2018 compared with the third quarter of fiscal 2017.

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Product development. Product development increased $0.4 million, or 6.2%, in the third quarter of fiscal 2018 primarily related to an increase of internal R&D headcount offset by a decrease in contract labor. We capitalized approximately $2.1 million and $3.6 million in total development costs during the three months ended December 31, 2017 and 2016, respectively.

Sales and marketing. Sales and marketing decreased $0.7 million, or 14.4%, in the third quarter of fiscal 2018 compared with the third quarter of fiscal 2017. The change is due primarily to a decrease of $0.3 million in payroll related expenses and $0.3 million in advertising and promotion related expenses.

General and administrative. General and administrative increased $2.4 million, or 66.2%, in the third quarter of fiscal 2018 compared with the third quarter of fiscal 2017 due primarily to increases of $1.5 million in stock compensation expense related to executive stock grants and the impact of removing forfeiture rates as a result of adopting ASU No. 2016-09 in the current year, coupled with forfeitures in the prior year due to the departure of former executives. Furthermore, during the third quarter of fiscal 2018 there was an increase of $0.5 million in professional fees related to legal, accounting and tax fees and other ongoing initiatives, and $0.3 million in increased bonus expense related to the forfeitures in the prior year due to the departure of former executives.

Restructuring, severance, and other charges. Restructuring, severance, and other charges decreased $1.0 million during the third quarter of fiscal 2018 compared to the third quarter of fiscal 2017. In the third quarter of fiscal 2018 we had $0.2 million in restructuring expense and $0.2 million in severance costs related to our ongoing efforts to better allocate resources to our crucial revenue growth areas while increasing internal efficiencies in other non-revenue generating areas. In the third quarter of fiscal 2017 we had $1.4 million in one-time charges related to the severance of our former CEO.

Legal Settlements. During the third quarter of fiscal 2018, we recorded $0.2 million in legal settlements.

Other Expenses (Income)

(Dollars in thousands)	Three months ended December 31, 2017	2016	(Unfavorable) favorable $	%
Other (income) expense:				
Interest income	$(13)	$(86)	$(73)	(84.9)%
Interest expense	3	3	—	— %
Other (income) expense, net	(46)	62	108	nm
Total other (income) expense, net	$(56)	$(21)	$35	nm

nm - not meaningful

Interest income. Interest income consists of interest earned on investments in certificates of deposit, commercial paper, corporate bonds, and corporate-owned life insurance policies.

Interest expense. Interest expense consists of costs associated with capital leases.

Other (income) expense. Other (income) expense consists mainly of the impact of foreign currency due to movement of European, Indian and Asian currencies against the US dollar.

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Income Taxes

	Three months ended December 31,		(Unfavorable) favorable	
(Dollars in thousands)	2017	2016	$	%
Income tax (benefit) expense	$(1,623)	$129	$ 1,752	nm
Effective tax rate	45.6 %	(8.0)%		

nm - not meaningful

For the three months ended December 31, 2017, the effective tax rate was different than the statutory rate due primarily to a $1.3 million benefit resulting from the effect of a reduction in the deferred rate due to passage of the Tax Act, recognition of net operating losses as deferred tax assets, which were offset by increases in the valuation allowance, certain foreign and state tax effects including a benefit of $0.4 million related to a settlement with the California Franchise Tax Board and other U.S. permanent book to tax differences.

For the three months ended December 31, 2016, the effective tax rate was different than the statutory rate due primarily to the recognition of net operating losses as deferred tax assets, which were offset by increases in the valuation allowance, certain foreign and state tax effects, and other U.S. permanent book to tax differences.

Although the timing and outcome of tax settlements are uncertain, it is reasonably possible that during the next 12 months a reduction in unrecognized tax benefits may occur in the range of zero to $0.1 million of tax and zero to $0.1 million of interest based on the outcome of tax examinations and as a result of the expiration of various statutes of limitations. We are routinely audited; due to the ongoing nature of current examinations in multiple jurisdictions, other changes could occur in the amount of gross unrecognized tax benefits during the next 12 months which cannot be estimated at this time. Additionally, we recognized a tax benefit in the amount of $0.4 million during the quarter as a result of a settlement with the California Franchise Tax Board regarding disputed tax matters.

We have recorded a valuation allowance offsetting substantially all of our deferred tax assets. The ultimate realization of deferred tax assets depends on the generation of future taxable income during the periods in which those temporary differences are deductible. Because of our losses in prior periods, management believes that it is more-likely-than-not that we will not realize the benefits of these deductible differences.

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Results of Operations

First Nine Months Fiscal 2018 Compared to First Nine Months Fiscal 2017

Net Revenue and Operating Loss

The following table presents our consolidated revenue and operating results for the nine months ended December 31, 2017 and 2016:

	Nine months ended December 31,		Increase (decrease)	
(Dollars in thousands)	2017	2016	$	%
Net revenue:				
Products	$25,758	$30,257	$(4,499)	(14.9)%
Support, maintenance and subscription services	50,990	47,087	3,903	8.3
Professional services	18,557	19,732	(1,175)	(6.0)
Total net revenue	95,305	97,076	(1,771)	(1.8)
Cost of goods sold:				
Products (inclusive of developed technology amortization)	19,862	22,217	(2,355)	(10.6)
Support, maintenance and subscription services	12,610	12,714	(104)	(0.8)
Professional services	15,160	13,835	1,325	9.6
Total cost of goods sold	47,632	48,766	(1,134)	(2.3)
Gross profit	47,673	48,310	(637)	(1.3)
Gross profit margin	50.0 %	49.8 %		
Operating expenses:				
Product development	20,708	20,647	61	0.3
Sales and marketing	13,616	15,746	(2,130)	(13.5)
General and administrative	18,475	13,692	4,783	34.9
Depreciation of fixed assets	1,892	1,791	101	5.6
Amortization of intangibles	1,421	1,031	390	37.8
Restructuring, severance and other charges	1,241	1,484	(243)	(16.4)
Legal settlements	150	85	65	76.5
Operating loss	$(9,830)	$(6,166)	$(3,664)	59.4 %

nm - not meaningful

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The following table presents the percentage relationship of our Condensed Consolidated Statement of Operations line items to our consolidated net revenues for the periods presented:

	Nine months ended December 31,	
	2017	2016
Net revenue:		
Products	27.0 %	31.2 %
Support, maintenance and subscription services	53.5	48.5
Professional services	19.5	20.3
Total	100.0 %	100.0 %
Cost of goods sold:		
Products (inclusive of developed technology amortization)	20.8 %	22.9 %
Support, maintenance and subscription services	13.2	13.0
Professional services	15.9	14.3
Total	50.0 %	50.2 %
Gross profit	50.0 %	49.8 %
Operating expenses:		
Product development	21.7 %	21.4 %
Sales and marketing	14.3	16.2
General and administrative	19.4	14.1
Depreciation of fixed assets	2.0	1.8
Amortization of intangibles	1.5	1.1
Restructuring, severance and other charges	1.3	1.5
Legal settlements	0.2	0.1
Operating loss	(10.3)%	(6.4)%

Net revenue. Total net revenue decreased $1.8 million, or 1.8%, during the first nine months of fiscal 2018 compared to the first nine months of fiscal 2017. Products revenue decreased $4.5 million, or 14.9%, during the first nine months of fiscal 2018 as compared to the first nine months of fiscal 2017 due primarily to decreased hardware sales. Support, maintenance and subscription services revenue increased $3.9 million, or 8.3%, compared to the first nine months of fiscal 2017 driven primarily by continued increases in subscription based service revenue, which increased 36.0% during the first nine months of fiscal 2018. Professional services revenue decreased $1.2 million, or 6.0% as a result of decreased volume of customer installation and implementation projects related to the sale of on premise and subscription based solutions.

Gross profit and gross profit margin. Our total gross profit decreased $0.6 million, or 1.3%, for the first nine months of fiscal 2018 and total gross profit margin increased 0.2% to 50.0%, from 49.8%. Products gross profit decreased $2.1 million and gross profit margin decreased 3.7% to 22.9% from 26.6% primarily as a result of an increase of $1.6 million of developed technology amortization related to our rGuest solutions. Support, maintenance and subscription services gross profit increased $4.0 million or 11.7% and gross profit margin increased 2.3% to 75.3% due to the scalable nature of our infrastructure supporting and hosting customers. Professional services gross profit decreased $2.5 million and gross profit margin decreased 11.6% to 18.3% as a re-deployment of internal resources that were previously not billable were converted into billable functions as a part of restructuring our professional services workforce into teams responsible for named customer accounts.

Operating expenses

Operating expenses, excluding the charges for asset write-offs and other fair value adjustments, legal settlements, and restructuring, severance and other charges, increased $3.2 million, or 6.1% during the first nine months of fiscal 2018 compared with the first nine months of fiscal 2017.

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Product development. Product development remained relatively flat in the first nine months of fiscal 2018 compared with the first nine months of fiscal 2017 which includes an increase of internal R&D headcount offset by a decrease in contract labor.

Sales and marketing. Sales and marketing decreased $2.1 million, or 13.5%, in the first nine months of fiscal 2018 compared with the first nine months of fiscal 2017. The change is due primarily to a decrease of $1.9 million in incentive commissions related to the revision of our commission plan from total contract value to annual contract value, and $0.3 million decrease in advertising and promotion.

General and administrative. General and administrative increased $4.8 million, or 34.9%, in the first nine months of fiscal 2018 compared with the first nine months of fiscal 2017 due primarily to increases of $2.5 million in stock compensation expense related to executive stock grants and the impact of removing forfeiture rates as a result of adopting ASU No. 2016-09, coupled with forfeitures in the prior year due to the departure of former executives. In addition, there was an increase of $0.9 million in salaries and wages as a result of additional headcount that included several key new hires, and an increase of $0.8 million in professional fees related to legal, accounting and tax fees and other ongoing initiatives.

Restructuring, severance, and other charges. Restructuring, severance, and other charges decreased $0.2 million during the first nine months of fiscal 2018 compared to the first nine months of fiscal 2017. In the first nine months of fiscal 2018 we had $1.0 million in restructuring expense and $0.2 million in severance costs related to our ongoing efforts to better allocate resources to our crucial revenue growth areas while increasing internal efficiencies in other non-revenue generating areas. In the first nine months of fiscal 2017 we had $1.4 million in one-time charges related primarily to the severance of our former CEO. The restructuring initiative will result in annual savings of $2.7 million across all of our operating expense categories.

Legal Settlements. During the first nine months of fiscal 2018, we recorded $0.2 million in legal settlements.

Other Expenses (Income)

	Nine months ended December 31,		(Unfavorable) favorable	
(Dollars in thousands)	2017	2016	$	%
Other (income) expense:				
Interest income	$(64)	$(135)	$(71)	(52.6)%
Interest expense	7	11	$4	36.4 %
Other (income) expense, net	(196)	140	336	240.0 %
Total other expense (income), net	$(253)	$16	$269	nm

Interest income. Interest income consists of interest earned on investments in certificates of deposit, commercial paper, corporate bonds, and corporate-owned life insurance policies.

Interest expense. Interest expense consists of costs associated with capital leases.

Other (income) expense. Other (income) expense consists mainly of the impact of foreign currency due to movement of European, Indian and Asian currencies against the US dollar.

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Income Taxes

	Nine months ended December 31,		(Unfavorable) favorable	
(Dollars in thousands)	2017	2016	$	%
Income tax (benefit) expense	$(1,439)	$252	$ 1,691	nm
Effective tax rate	15.0 %	(4.1)%		

nm - not meaningful

For the nine months ended December 31, 2017, the effective tax rate was different than the statutory rate due primarily to a $1.3 million benefit resulting from the effect of a reduction in the deferred rate due to passage of the Tax Act, recognition of net operating losses as deferred tax assets, which were offset by increases in the valuation allowance, certain foreign and state tax effects including a benefit of $0.4 million related to a settlement with the California Franchise Tax Board and other U.S. permanent book to tax differences.

For the nine months ended December 31, 2016, the effective tax rate was different than the statutory rate due primarily to the recognition of net operating losses as deferred tax assets, which were offset by increases in the valuation allowance, certain foreign and state taxes, and other U.S. permanent book to tax differences.

Although the timing and outcome of tax settlements are uncertain, it is reasonably possible that during the next 12 months a reduction in unrecognized tax benefits may occur in the range of zero to $0.1 million of tax and zero to $0.1 million of interest based on the outcome of tax examinations and as a result of the expiration of various statutes of limitations. We are routinely audited; due to the ongoing nature of current examinations in multiple jurisdictions, other changes could occur in the amount of gross unrecognized tax benefits during the next 12 months which cannot be estimated at this time. Additionally, we recognized a tax benefit in the amount of $0.4 million during the quarter as a result of a settlement with the California Franchise Tax Board regarding disputed tax matters.

We have recorded a valuation allowance offsetting substantially all of our deferred tax assets. The ultimate realization of deferred tax assets depends on the generation of future taxable income during the periods in which those temporary differences are deductible. Because of our losses in prior periods, management believes that it is more-likely-than-not that we will not realize the benefits of these deductible differences.

Liquidity and Capital Resources

Overview

Our operating cash requirements consist primarily of working capital needs, operating expenses, and capital expenditures. We believe that cash flow from operating activities, cash on hand of $37.6 million as of December 31, 2017 and access to capital markets will provide adequate funds to meet our short- and long-term liquidity requirements in the next 12 months.

As of December 31, 2017 and March 31, 2017, our total debt was approximately $0.2 million, comprised of capital lease obligations in both periods.

At December 31, 2017, 100% of our cash and cash equivalents were deposited in bank accounts or invested in highly liquid investments with original maturities of three months or less. We maintain approximately 92% of our cash and cash equivalents in the United States. Therefore, we believe that credit risk is limited with respect to our cash and cash equivalents.

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Cash Flow

(In thousands)	Nine months ended December 31, 2017	2016
Net cash provided by (used in):		
Operating activities	$2,098	$5,393
Investing activities	(12,588)	(12,502)
Financing activities	(1,282)	(687)
Effect of exchange rate changes on cash	132	(99)
Net decrease in cash and cash equivalents	$(11,640)	$(7,895)

Cash flow provided by operating activities. Cash flow provided by operating activities was $2.1 million in the first nine months of fiscal 2018. Operating assets and liabilities decreased $3.4 million due mainly to the timing of collections and operating loss of $8.1 million were offset by non-cash charges of $10.7 million in depreciation and amortization and $3.8 million in share-based compensation. Total share-based compensation increased $3.0 million for the nine months ended December 31, 2017 due to higher value executive stock grants and the impact of removing forfeiture rates.

Cash flow used in investing activities. For the first nine months of fiscal 2018, the $12.6 million in cash used in investing activities was primarily comprised of $7.3 million for the development of proprietary software and $5.3 million for purchase of property and equipment, and internal use software development.

Cash flow used in financing activities. During the first nine months of fiscal 2018, the $1.3 million used in financing activities was primarily comprised of $1.2 million related to the repurchase of shares to satisfy employee tax withholding.

Contractual Obligations

In December 2017, the Company entered into a new lease for an office in Singapore. The lease term commenced in December 2017 upon possession by the Company. The total commitment for this lease is approximately $1.0 million over a 36-month period.

In December 2017, the Company entered into a new lease for an inventory warehouse in Roswell, GA. The lease term commenced in January 2018 upon possession by the Company. The total commitment for this lease is approximately $0.2 million over a 62-month period.

As of December 31, 2017, there were no other significant changes to our contractual obligations as presented in our Annual Report for the year ended March 31, 2017.

Off-Balance Sheet Arrangements

We have not entered into any off-balance sheet arrangements that have had or are reasonably likely to have a current or future effect on our financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures, or capital resources.

Critical Accounting Policies

A detailed description of our significant accounting policies is included in our Annual Report for the year ended March 31, 2017. There have been no material changes in our significant accounting policies and estimates since

March 31, 2017 except as noted in Note 2, Summary of Significant Accounting Policies.

Forward-Looking Information

This Quarterly Report and other publicly available documents, including the documents incorporated herein and therein by reference, contain, and our officers and representatives may from time to time make, "forward-looking statements" within the meaning of the safe harbor provisions of the U.S. Private Securities Litigation Reform Act of 1995. Forward-looking statements can be identified by words such as: "anticipate," "intend," "plan," "goal," "seek," "believe," "project," "estimate," "expect," "strategy," "future," "likely," "may," "should," "will" and similar references to future periods. Forward-looking statements are neither historical facts nor assurances of future performance. Instead, they are based only on our current beliefs, expectations and assumptions regarding the future of our business, future plans and strategies, projections, anticipated events and trends, the economy and other future conditions. Because forward-looking statements relate to the future, they are subject to inherent uncertainties, risks and changes in circumstances that are difficult to predict and many of which are outside of our control. Our actual results and financial condition may differ materially from those indicated in the forward-looking statements. Therefore, you should not rely on any of these forward-looking statements. Important factors that could cause our actual results and financial condition to differ materially from those indicated in the forward-looking statements include, among others, our ability to achieve operational efficiencies and meet customer demand for products and services and the risk factors set forth in Item 1A in Part II of this Quarterly Report and Item IA of our Annual Report for the fiscal year ended March 31, 2017. Any forward-looking statement made by us in this Quarterly Report is based only on information currently available to us and speaks only as of the date on which it is made. We undertake no obligation to publicly update any forward-looking statement made in this Quarterly Report or any other forward-looking statement that may be made from time to time, whether written or oral, whether as a result of new information, future events, or otherwise.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

For quantitative and qualitative disclosures about market risk affecting us, see Item 7A, “Quantitative and Qualitative Disclosures About Market Risk,” contained in our Annual Report for the fiscal year ended March 31, 2017. There have been no material changes in our market risk exposures since March 31, 2017.

Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

Under the supervision of and with the participation of our Chief Executive Officer (CEO), Chief Financial Officer (CFO) and Corporate Controller and Treasurer, management evaluated the effectiveness of the design and operation of our disclosure controls and procedures, as defined in Rules 13a-15(e) and 15d-15(e) promulgated under the Securities Exchange Act of 1934, as amended, as of the end of the period covered by this Quarterly Report. Based on that evaluation, the CEO, CFO and Corporate Controller and Treasurer concluded that, as of the end of the period covered by this Quarterly Report, our disclosure controls and procedures were effective.

Change in Internal Control over Financial Reporting

None.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

None.

Item 1A. Risk Factors

There have been no material changes in the risk factors included in our Annual Report for the fiscal year ended March 31, 2017 that may materially affect our business, results of operations, or financial condition.

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

None.

Item 3. Defaults Upon Senior Securities

None.

Item 4. Mine Safety Disclosures

Not applicable.

Item 5. Other Information

None.

Item 6. Exhibits

31.1	Rule 13a-14(a)/15d-14(a) Certification of Chief Executive Officer.
31.2	Rule 13a-14(a)/15d-14(a) Certification of Chief Financial Officer.
31.3	Rule 13a-14(a)/15d-14(a) Certification of Corporate Controller and Treasurer.
32	Certification of Chief Executive Officer, Chief Financial Officer and Corporate Controller and Treasurer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of Sarbanes-Oxley Act of 2002.
101	The following materials from our quarterly report on Form 10-Q for the quarter ended December 31, 2017, formatted in XBRL (Extensible Business Reporting Language): (i) Condensed Consolidated Balance Sheets at December 31, 2017 and March 31, 2017, (ii) Condensed Consolidated Statements of Operations for the three and nine months ended December 31, 2017 and 2016, (iii) Condensed Consolidated Statements of Comprehensive Loss for the three and nine months ended December 31, 2017 and 2016, (iv) Condensed Consolidated Statements of Cash Flows for the nine months ended December 31, 2017 and 2016, and (v) Notes to Condensed Consolidated Financial Statements for the three and nine months ended December 31, 2017.

SIGNATURE

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

AGILYSYS, INC.

Date:	January 26, 2018	/s/ Anthony S. Pritchett
		Anthony S. Pritchett
		Chief Financial Officer
		(Principal Financial Officer and Duly Authorized Officer)