

CSP INC /MA/
Form 10-Q
February 14, 2018

United States
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

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 0-10843

CSP Inc.
(Exact name of Registrant as specified in its charter)

Massachusetts 04-2441294
(State or other jurisdiction of incorporation or organization) (I.R.S. Employer Identification No.)

175 Cabot Street - Suite 210, Lowell, Ma 01854
(Address of principle executive offices) (Zip Code)

(978)-954-5038
(Registrant's telephone number, including area code)

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

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

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

Large accelerated filer Accelerated filer

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

Emerging growth company

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

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

As of February 13, 2018, the registrant had 3,983,084 shares of common stock issued and outstanding.

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

CSP INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
(Amounts in thousands, except par value)

| | December 31, 2017 | September 30, 2017 (Unaudited) |
|--|----------------------|--------------------------------------|
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 18,190 | \$ 13,885 |
| Accounts receivable, net of allowances of \$240 and \$261 | 19,935 | 27,630 |
| Unbilled accounts receivable | 1,169 | 772 |
| Inventories | 7,158 | 5,971 |
| Deferred costs | 2,156 | 929 |
| Other current assets | 3,105 | 1,139 |
| Total current assets | 51,713 | 50,326 |
| Property, equipment and improvements, net | 1,482 | 1,508 |
| Other assets: | | |
| Intangibles, net | 137 | 167 |
| Deferred costs | 647 | 609 |
| Deferred income taxes | 2,350 | 2,827 |
| Cash surrender value of life insurance | 3,395 | 3,300 |
| Other assets | 193 | 191 |
| Total other assets | 6,722 | 7,094 |
| Total assets | \$ 59,917 | \$ 58,928 |
| LIABILITIES AND SHAREHOLDERS' EQUITY | | |
| Current liabilities: | | |
| Accounts payable and accrued expenses | \$ 21,313 | \$ 18,845 |
| Deferred revenue | 5,624 | 6,202 |
| Pension and retirement plans | 539 | 534 |
| Income taxes payable | 316 | 442 |
| Total current liabilities | 27,792 | 26,023 |
| Pension and retirement plans | 11,914 | 11,818 |
| Income taxes payable | 561 | — |
| Other long term liabilities | 160 | 86 |
| Total liabilities | 40,427 | 37,927 |
| Commitments and contingencies | | |
| Shareholders' equity: | | |
| Common stock, \$.01 par value per share; authorized, 7,500 shares; issued and outstanding 3,974 and 3,935 shares, respectively | 40 | 40 |
| Additional paid-in capital | 13,847 | 13,717 |
| Retained earnings | 15,770 | 17,407 |
| Accumulated other comprehensive loss | (10,167 |) (10,163) |

| | | |
|--|-----------|-----------|
| Total shareholders' equity | 19,490 | 21,001 |
| Total liabilities and shareholders' equity | \$ 59,917 | \$ 58,928 |

See accompanying notes to unaudited consolidated financial statements.

CSP INC. AND SUBSIDIARIES
 UNAUDITED CONSOLIDATED STATEMENTS OF OPERATIONS

(Amounts in thousands, except for per share data)

| | For the three months ended | |
|---|-------------------------------|----------------------|
| | December 31, 2017 | December 31, 2016 |
| Sales: | | |
| Product | \$ 15,643 | \$ 14,638 |
| Services | 6,356 | 5,278 |
| Total sales | 21,999 | 19,916 |
| Cost of sales: | | |
| Product | 13,030 | 12,225 |
| Services | 3,836 | 3,239 |
| Total cost of sales | 16,866 | 15,464 |
| Gross profit | 5,133 | 4,452 |
| Operating expenses: | | |
| Engineering and development | 698 | 596 |
| Selling, general and administrative | 4,428 | 3,958 |
| Total operating expenses | 5,126 | 4,554 |
| Operating income (loss) | 7 | (102) |
| Other income (expense): | | |
| Foreign exchange gain (loss) | (93) | 54) |
| Other expense, net | (12) | (10) |
| Total other income (expense) | (105) | 44) |
| Loss before income taxes | (98) | (58) |
| Income tax expense (benefit) | 1,102 | (15) |
| Net loss | \$(1,200) | \$ (43) |
| Net loss attributable to common stockholders | \$(1,200) | \$ (43) |
| Net loss per share – basic | \$(0.32) | \$ (0.01) |
| Weighted average shares outstanding – basic | 3,768 | 3,671 |
| Net loss per share – diluted | \$(0.32) | \$ (0.01) |
| Weighted average shares outstanding – diluted | 3,768 | 3,671 |

See accompanying notes to unaudited consolidated financial statements.

CSP INC. AND SUBSIDIARIES
 UNAUDITED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)
 (Amounts in thousands)

| | For the three months ended | |
|--|-------------------------------|----------------------|
| | December 31, 2017 | December 31, 2016 |
| Net loss | \$(1,200) | \$ (43) |
| Other comprehensive income (loss): | | |
| Foreign currency translation gain (loss) adjustments | (4) | 138 |
| Other comprehensive income (loss) | (4) | 138 |
| Total comprehensive income (loss) | \$(1,204) | \$ 95 |

See accompanying notes to unaudited consolidated financial statements.

CSP INC. AND SUBSIDIARIES

UNAUDITED CONSOLIDATED STATEMENT OF SHAREHOLDERS' EQUITY

For the three Months Ended December 31, 2017:

(Amounts in thousands, except per share data)

| | Shares | Amount | Additional Paid-in Capital | Retained Earnings | Accumulated other comprehensive loss | Total Shareholders' Equity |
|---|--------|--------|----------------------------------|----------------------|---|----------------------------------|
| Balance as of September 30, 2017 | 3,935 | \$ 40 | \$ 13,717 | \$ 17,407 | \$ (10,163) | \$ 21,001 |
| Net loss | — | — | — | (1,200) | — | (1,200) |
| Other comprehensive loss | — | — | — | — | (4) | (4) |
| Exercise of stock options | 1 | — | 9 | — | — | 9 |
| Stock-based compensation | — | — | 121 | — | — | 121 |
| Restricted stock cancellation | (13) | — | — | — | — | — |
| Restricted stock issuance | 51 | — | — | — | — | — |
| Cash dividends declared on common stock (\$0.11 per share) | — | — | — | (437) | — | (437) |
| Balance as of December 31, 2017 | 3,974 | \$ 40 | \$ 13,847 | \$ 15,770 | \$ (10,167) | \$ 19,490 |

See accompanying notes to unaudited consolidated financial statements.

CSP INC. AND SUBSIDIARIES
UNAUDITED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Amounts in thousands)

| | For the three months ended | |
|---|-------------------------------|----------------------|
| | December 31, 2017 | December 31, 2016 |
| Cash flows provided by operating activities: | | |
| Net loss | \$(1,200) | \$ (43) |
| Adjustments to reconcile net loss to net cash provided by operating activities: | | |
| Depreciation and amortization | 141 | 126 |
| Amortization of intangibles | 30 | 31 |
| Loss on sale of fixed assets, net | 5 | — |
| Foreign exchange gain (loss) | 93 | (54) |
| Non-cash changes in accounts receivable | (8) | 41 |
| Non-cash changes in inventories | 127 | 62 |
| Stock-based compensation expense on stock options and restricted stock awards | 121 | 108 |
| Deferred income taxes | 490 | (4) |
| Increase in cash surrender value of life insurance | (29) | (46) |
| Changes in operating assets and liabilities: | | |
| Decrease in accounts receivable | 7,423 | 2,039 |
| Decrease in life insurance receivable | — | 413 |
| Increase in inventories | (1,299) | (1,079) |
| Increase in deferred costs | (1,219) | (1,938) |
| (Increase) decrease in refundable income taxes | 1 | (148) |
| Increase in other current assets | (1,939) | (190) |
| Increase in accounts payable and accrued expenses | 1,990 | 3,244 |
| Decrease in deferred revenue | (652) | (86) |
| Decrease in pension and retirement plans liabilities | (27) | (27) |
| Increase (decrease) in income taxes payable | 435 | (159) |
| Increase in other long term liabilities | 71 | 2 |
| Net cash provided by operating activities | 4,554 | 2,292 |
| Cash flows used in investing activities: | | |
| Life insurance premiums paid | (66) | — |
| Purchases of property, equipment and improvements | (109) | (72) |
| Net cash used in investing activities | (175) | (72) |
| Cash flows provided by financing activities: | | |
| Proceeds from issuance of shares under equity compensation plans | 9 | — |
| Net cash provided by financing activities | 9 | — |
| Effects of exchange rate on cash | (83) | (284) |
| Net increase in cash and cash equivalents | 4,305 | 1,936 |
| Cash and cash equivalents, beginning of period | 13,885 | 13,103 |
| Cash and cash equivalents, end of period | \$18,190 | \$ 15,039 |
| Supplementary cash flow information: | | |
| Cash paid for income taxes | \$95 | \$ 165 |
| Cash paid for interest | \$72 | \$ 75 |
| Non-cash accrual of dividend payable | \$437 | \$ — |

See accompanying notes to unaudited consolidated financial statements.

CSP INC. AND SUBSIDIARIES
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS
FOR THE THREE MONTHS ENDED DECEMBER 31, 2017 AND 2016

Organization and Business

CSP Inc. ("CSPI" or "the Company" or "we" or "our") was incorporated in 1968 and is based in Lowell, Massachusetts. To meet the diverse requirements of its commercial and defense customers worldwide, CSPI and its subsidiaries develop and market IT integration solutions, advanced security and managed services, purpose built network adapters, and high-performance cluster computer systems. The Company operates in two segments, its High Performance Products ("HPP") segment and its Technology Solutions ("TS") segment.

1. Basis of Presentation

The accompanying consolidated financial statements have been prepared by the Company, without audit, and reflect all adjustments which, in the opinion of management, are necessary for a fair statement of the results of the interim periods presented. All adjustments were of a normal recurring nature. Certain information and footnote disclosures normally included in the annual consolidated financial statements, which are prepared in accordance with accounting principles generally accepted in the United States, have been omitted.

Accordingly, the Company believes that although the disclosures are adequate to make the information presented not misleading, the unaudited consolidated financial statements should be read in conjunction with the footnotes contained in the Company's Annual Report on Form 10-K for the fiscal year ended September 30, 2017.

2. Use of Estimates

The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period, including estimates and assumptions related to reserves for bad debt, reserves for inventory obsolescence, the impairment assessment of intangible assets, the calculation of estimated selling price and post-delivery support obligations used for revenue recognition, the calculation of liabilities related to deferred compensation and retirement plans and the calculation of income tax liabilities. Actual results may differ from those estimates under different assumptions or conditions.

3. Earnings Per Share of Common Stock

Basic net income per common share is computed by dividing net income available to common shareholders by the weighted average number of common shares outstanding for the period. Diluted net income per common share reflects the maximum dilution that would have resulted from the assumed exercise and share repurchase related to dilutive stock options and is computed by dividing net income by the assumed weighted average number of common shares outstanding.

We are required to present earnings per share, or EPS, utilizing the two class method because we had outstanding, non-vested share-based payment awards that contain non-forfeitable rights to dividends or dividend equivalents, which are considered participating securities.

Basic and diluted earnings per share computations for the Company's reported net income attributable to common stockholders are as follows:

| | For the three months ended | |
|--|--|----------------------|
| | December 31, 2017 | December 31, 2016 |
| | (Amounts in thousands except per share data) | |
| Net loss | \$(1,200) | \$(43) |
| Less: net income attributable to nonvested common stock | — | — |
| Net loss attributable to common stockholders | \$(1,200) | \$(43) |
| Weighted average total shares outstanding – basic | 3,768 | 3,671 |
| Less: weighted average non-vested shares outstanding | — | — |
| Weighted average number of common shares outstanding – basic | 3,768 | 3,671 |
| Potential common shares from non-vested stock awards and the assumed exercise of stock options | — | — |
| Weighted average common shares outstanding – diluted | 3,768 | 3,671 |
| Net loss per share – basic | \$(0.32) | \$(0.01) |
| Net loss per share – diluted | \$(0.32) | \$(0.01) |

Non-vested restricted stock awards of 170,000 and 149,000 shares were excluded from the diluted income per share calculation for the three months ended December 31, 2017 and December 31, 2016, respectively, as there was a net loss and their inclusion would have been anti-dilutive.

4. Inventories

Inventories consist of the following:

| | December 2017 | September 30, 2017 |
|-----------------|---------------------------|-----------------------|
| | (Amounts in thousands) | |
| Raw materials | \$ 1,395 | \$ 1,334 |
| Work-in-process | 206 | 260 |
| Finished goods | 5,557 | 4,377 |
| Total | \$ 7,158 | \$ 5,971 |

Finished goods includes inventory that has been shipped, but for which all revenue recognition criteria has not been met, of approximately \$0.1 million and \$0.4 million as of December 31, 2017 and September 30, 2017, respectively.

Total inventory balances in the table above are shown net of reserves for obsolescence of approximately \$3.2 million and \$3.1 million as of December 31, 2017 and September 30, 2017, respectively.

5. Deferred Costs

Deferred costs represent costs of labor, third party maintenance and support contracts, and outside consultants related to transactions where the revenue recognition criteria has not been met.

6. Accumulated Other Comprehensive Loss

The components of accumulated other comprehensive loss are as follows:

| | December 31, 2017 | September 30, 2017 |
|---|------------------------|-----------------------|
| | (Amounts in thousands) | |
| Cumulative effect of foreign currency translation | \$(3,218) | \$ (3,214) |
| Cumulative unrealized loss on pension liability | (6,949) | (6,949) |
| Accumulated other comprehensive loss | \$(10,167) | \$ (10,163) |

7. Income Taxes

On December 22, 2017, the United States enacted tax reform legislation commonly known as the Tax Cuts and Jobs Act (the “Act”), resulting in significant modifications to existing law. The Company follows the guidance in SEC Staff Accounting Bulletin 118 (“SAB 118”), which provides additional clarification regarding the application of ASC Topic 740 in situations where the Company does not have the necessary information available, prepared, or analyzed in reasonable detail to complete the accounting for certain income tax effects of the Act for the reporting period in which the Act was enacted. SAB 118 provides for a measurement period beginning in the reporting period that includes the Act’s enactment date and ending when the Company has obtained, prepared, and analyzed the information needed in order to complete the accounting requirements but in no circumstances should the measurement period extend beyond one year from the enactment date.

During the first quarter ended December 31, 2017, the Company recognized a provision for income taxes of \$1.1 million that includes a provisional estimate in the amount of \$649 thousand related to the one-time deemed repatriation transition tax on unrepatriated foreign earnings. The provisional amount is based on information currently available, including estimated tax earnings and profits from foreign investments. The Company continues to gather and analyze information, including historical adjustments to earnings and profits of foreign subsidiaries, in order to complete the accounting for the effects of the estimated transition tax. This expense has been recorded discretely in the quarter ending December 31, 2017.

The Company has also recorded a provisional estimate for a one-time tax expense of \$490 thousand which consists primarily of the remeasurement of deferred tax assets and liabilities from 34% to 21%. This expense has also been recorded discretely in the quarter ending December 31, 2017.

The Company is using a blended federal rate of roughly 24% for the fiscal year ending September 30, 2018 and will use the 21% for periods after fiscal year 2018.

The provisions above are estimates, and accordingly, changes to these estimates will be recorded in subsequent quarters as more information and guidance becomes available.

Given the timing of enactment and the breadth and complexity of the legislation, additional time is needed to obtain, prepare and analyze information related to possible income tax effects of other legislative changes as a result of the Act.

8. Pension and Retirement Plans

The Company has defined benefit and defined contribution plans in the United Kingdom, Germany and the U.S. In the United Kingdom and Germany, the Company provides defined benefit pension plans and defined contribution plans for some of its employees. In the U.S., the Company provides benefits through supplemental retirement plans to certain former employees. The domestic supplemental retirement plans have life insurance policies which are not plan

assets but were purchased by the Company as a vehicle to fund the costs of the plan. Domestically, the Company also provides for officer death benefits through post-retirement plans to certain officers. All of the Company's defined benefit plans are closed to newly hired employees and have been since September 2009.

The Company funds its pension plans in amounts sufficient to meet the requirements set forth in applicable employee benefits laws and local tax laws. Liabilities for amounts in excess of these funding levels are accrued and reported in the consolidated balance sheets.

The Company's pension plan in the United Kingdom is the only plan with plan assets. The plan assets consist of an investment in a commingled fund which in turn comprises a diversified mix of assets including corporate equity securities, government securities and corporate debt securities.

The components of net periodic benefit costs related to the U.S. and international plans are as follows:

| | For the Three Months Ended December | | | | | |
|---------------------------------|-------------------------------------|------|-------|---------|------|-------|
| | 31, 2017 | | | 2016 | | |
| | Foreign | U.S. | Total | Foreign | U.S. | Total |
| | (Amounts in thousands) | | | | | |
| Pension: | | | | | | |
| Service cost | \$10 | \$— | \$10 | \$10 | \$— | \$10 |
| Interest cost | 116 | 7 | 123 | 93 | 11 | 104 |
| Expected return on plan assets | (75) | — | (75) | (65) | — | (65) |
| Amortization of: | | | | | | |
| Amortization of net gain (loss) | 60 | (1) | 59 | 91 | (1) | 90 |
| Net periodic benefit cost | \$111 | \$6 | \$117 | \$129 | \$10 | \$139 |
| Post Retirement: | | | | | | |
| Service cost | \$— | \$10 | \$10 | \$— | \$10 | \$10 |
| Interest cost | — | 12 | 12 | — | 10 | 10 |
| Amortization of net gain (loss) | — | (4) | (4) | — | 4 | 4 |
| Net periodic cost (benefit) | \$— | \$18 | \$18 | \$— | \$24 | \$24 |

The fair value of the assets held by the U.K. pension plan by asset category are as follows:

| Asset Category | Fair Values as of December 31, 2017 | | | | September 30, 2017 | | | | |
|-------------------|---|------------|------------|------------|---|------------|------------|------------|---|
| | Total | Level 1 | Level 2 | Level 3 | Total | Level 1 | Level 2 | Level 3 | |
| | Fair Value Measurements Using Inputs Considered as | | | | Fair Value Measurements Using Inputs Considered as | | | | |
| | (Amounts in thousands) | | | | | | | | |
| Cash on deposit | \$51 | \$51 | \$ | —\$ | —\$62 | \$62 | \$ | —\$ | — |
| Pooled funds | 8,428 | 8,428 | — | — | 8,177 | 8,177 | — | — | |
| Total plan assets | \$8,479 | \$8,479 | \$ | —\$ | —\$8,239 | \$8,239 | \$ | —\$ | — |

9. Segment Information

The following tables presents certain operating segment information for the three months ended December 31, 2017 and December 31, 2016.

| For the three months ended December 31, | Technology Solutions Segment | | | | | Consolidated Total |
|---|---|---------|----------------|----------|----------|--------------------|
| | High Performance Products Segment (Amounts in thousands) | Germany | United Kingdom | U.S. | Total | |
| 2017 | | | | | | |
| Sales: | | | | | | |
| Product | \$1,607 | \$1,974 | \$2,542 | \$9,520 | \$14,036 | \$15,643 |
| Service | 863 | 3,395 | 165 | 1,933 | 5,493 | 6,356 |
| Total sales | 2,470 | 5,369 | 2,707 | 11,453 | 19,529 | 21,999 |
| Income (loss) from operations | (382) | (158) | 142 | 405 | 389 | 7 |
| Assets | 16,664 | 20,949 | 2,520 | 19,784 | 43,253 | 59,917 |
| Capital expenditures | 10 | 65 | — | 34 | 99 | 109 |
| Depreciation and amortization | 56 | 47 | 1 | 67 | 115 | 171 |
| 2016 | | | | | | |
| Sales: | | | | | | |
| Product | \$1,527 | \$2,080 | \$701 | \$10,330 | \$13,111 | \$14,638 |
| Service | 1,224 | 3,059 | 104 | 891 | 4,054 | 5,278 |
| Total sales | 2,751 | 5,139 | 805 | 11,221 | 17,165 | 19,916 |
| Income (loss) from operations | 46 | (102) | (206) | 160 | (148) | (102) |
| Assets | 17,766 | 15,532 | 2,873 | 14,531 | 32,936 | 50,702 |
| Capital expenditures | 17 | 44 | — | 11 | 55 | 72 |
| Depreciation and amortization | 55 | 38 | 3 | 61 | 102 | 157 |

Income (loss) from operations consists of sales less cost of sales, engineering and development expenses, and selling, general and administrative expenses but is not affected by either other income/expense or by income taxes expense/benefit. Non-operating charges/income consists principally of investment income and interest expense. All intercompany transactions have been eliminated.

The following table lists customers from which the Company derived revenues in excess of 10% of total revenues for the three months ended December 31, 2017, and 2016.

| | For the three months ended December 31, | |
|------------|--|---------------------------------------|
| | 2017 | 2016 |
| | % of Customer Total Revenues | % of Customer Total Revenues |
| Customer A | \$1.2 6 % | \$2.9 14 % |
| Customer B | \$2.5 11 % | \$2.1 11 % |

In addition, accounts receivable from Customer A totaled approximately \$1.0 million, or 5%, and approximately \$2.4 million, or 9%, of total consolidated accounts receivable as of December 31, 2017 and September 30, 2017,

respectively. Accounts receivable from Customer B totaled approximately \$3.3 million, or 16%, and approximately \$3.9 million, or 14%, of total consolidated accounts receivable as of December 31, 2017 and September 30, 2017, respectively.

Two additional customers, C and D, each accounted for account receivable of 10% or more, but did not account for revenue of 10% or more. Accounts receivable from customer C totaled approximately \$2.8 million, or 13%, of consolidated accounts receivable as of December 31, 2017. Accounts receivable from customer D totaled approximately \$2.3 million, or 11%, of consolidated accounts receivable as of December 31, 2017. We believe that the Company is not exposed to any significant credit risk with respect to the accounts receivable with these customers as of December 31, 2017. No other customers accounted for 10% or more of total consolidated accounts receivable as of December 31, 2017.

10. Dividends

On December 19, 2017, the Company's board of directors declared a cash dividend of \$0.11 per share which was paid on January 16, 2018 to shareholders of record as of December 29, 2017, the record date.

11. Recent Accounting Pronouncements

Accounting standards recently adopted

Effective September 30, 2017, the Company adopted FASB ASU No. 2014-15, Disclosure of Uncertainties about an Entity's Ability to Continue as a Going Concern, an amendment of the FASB Accounting Standards Codification. The ASU has added additional disclosure requirements to the codification. It requires management to assess, at each interim and annual reporting period, whether substantial doubt exists about an entity's ability to continue as a going concern. Substantial doubt exists if it is probable (the "probable" threshold under GAAP has generally been interpreted to be between 75 and 80 percent) that the entity will be unable to meet its obligations as they become due within one year after the date the financial statements are issued or available to be issued (assessment date). This guidance did not have an impact to the Company's consolidated financial statements.

In November 2015, the FASB issued ASU No. 2015-17, Income Taxes (Topic 740) Balance Sheet Classification of Deferred Taxes, which require that deferred tax liabilities and assets be classified as noncurrent in a classified statement of financial position. The amendments in this Topic apply to all entities that present a classified statement of financial position. The current requirement that deferred tax liabilities and assets of a tax-paying component of an entity be offset and presented as a single amount is not affected by the amendments in this Topic. The amendments in this Topic are effective for financial statements issued for annual periods beginning after December 15, 2016, and interim periods within those annual periods. Beginning October 1, 2017, the Company adopted the ASU and it hasn't had a material impact on our consolidated financial statements. As a result of the adoption of this ASU, the Company reclassified the current deferred tax asset previously reported on the September 30, 2017 balance sheet to the noncurrent deferred tax asset.

In March 2016, the FASB issued ASU No. 2016-09 (Topic 718), Compensation - Stock Compensation, Improvements to Employee Share-Based Payment Accounting to simplify several aspects of the accounting for share-based payment transactions, including the income tax consequences, classification of awards as either equity or liabilities, and classification on the statement of cash flows. Additionally, the amendments eliminate the guidance in Topic 718 that was indefinitely deferred shortly after the issuance of FASB Statement No. 123 (revised 2004), Share-Based Payment. This should not result in a change in practice because the guidance that is being superseded was never effective. The Company has adopted this ASU effective October 1, 2017 and it hasn't had a material impact on our consolidated financial statements.

New accounting standards not adopted as of December 31, 2017

In May 2014, the FASB issued ASU No. 2014-09, Revenue from Contracts with Customers, which requires an entity to recognize the amount of revenue to which it expects to be entitled for the transfer of promised goods or services to customers. The ASU will replace most existing revenue recognition guidance in GAAP when it becomes effective. The new standard is effective for the Company on October 1, 2018, and it does not plan to early adopt this ASU. The standard outlines a five-step model whereby revenue is recognized as performance obligations within a contract are satisfied. The standard also requires new, expanded disclosures regarding revenue recognition. We are utilizing a bottom-up approach to analyze the standard's impact on our contract portfolio, comparing our historical accounting policies and practices, and identifying potential differences from applying the requirements of the new standard to our contracts. While this assessment continues, we have not yet completed our determination of the impacts of the standard or the effect of these impacts on our consolidated financial statements. The Company has selected the modified retrospective approach as its transition method. Because the new standard will impact our business processes, systems and controls, we are developing a comprehensive change management project plan to guide the implementation.

In July 2015, the FASB issued ASU No. 2015-11, Inventory (Topic 330) Simplifying the Measurement of Inventory, which requires entities to measure inventory at the lower of cost and net realizable value, except for inventory measured using last-in, first-out (LIFO) or the retail inventory method. Net realizable value is the estimated selling prices in the ordinary course of business, less reasonably predictable costs of completion, disposal, and transportation. This ASU is effective for fiscal years beginning after December 15, 2016, and interim periods within fiscal years beginning after December 15, 2017 and requires prospective application, with early adoption permitted as of the beginning of an interim or annual reporting period. The Company has not yet assessed the potential impact of implementing this ASU on our consolidated financial statements.

In February 2016, the FASB issued ASU 2016-02, Leases (Topic 842), an amendment of the FASB Accounting Standards Codification. This ASU requires lessees to recognize a right-of-use asset and lease liability for most lease arrangements. The new standard is effective for the Company on October 1, 2019. The standard mandates a modified retrospective transition method for all entities and early adoption is permitted. The Company is evaluating the effect that ASU 2016-02 will have on its consolidated financial statements and related disclosures.

In March 2016, the FASB issued ASU No. 2016-08 (Topic 606), Principal versus Agent Considerations (Reporting Revenue Gross versus Net) to clarify the implementation guidance on principal versus agent considerations. The amendments in this update provides additional guidance on indicators to assist an entity in determining whether it controls a specified good or service before it is transferred to the customer and does not change the core principle of previously issued guidance. The amendments in this Topic are effective for financial statements issued for annual periods beginning after December 15, 2017, and interim periods within those annual periods. The Company does not expect the implementation of this ASU to have a material impact on our consolidated financial statements.

In August 2016, the FASB issued ASU No. 2016-15, Classification of Certain Cash Receipts and Cash Payments, an amendment of the FASB Accounting Standards Codification. This ASU will reduce diversity in practice for classifying cash payments and receipts in the statement of cash flows for a number of common transactions. It will also clarify when identifiable cash flows should be separated versus classified based on their predominant source or use. This ASU is effective for public business entities for fiscal years beginning after December 15, 2017, and interim periods within those fiscal years. Early adoption is permitted, including adoption in an interim period. If an entity early adopts the amendments in an interim period, any adjustments should be reflected as of the beginning of the fiscal year that includes that interim period. An entity that elects early adoption must adopt all of the amendments in the same period. The Company is evaluating the effect that ASU 2016-15 will have on its consolidated financial statements and related disclosures.

In October 2016, the FASB issued ASU No. 2016-16, Intra-Entity Transfers of Assets Other Than Inventory, an amendment of the FASB Accounting Standards Codification. This ASU requires the seller and buyer to recognize at the transaction date the current and deferred income tax consequences of intercompany asset transfers (except transfers of inventory). Under current GAAP, the seller and buyer defer the consolidated tax consequences of an intercompany asset transfer from the period of the transfer to a future period when the asset is transferred out of the consolidated group, or otherwise affects consolidated earnings. This standard will cause volatility in companies' effective tax rates, particularly for those that transfer intangible assets to foreign subsidiaries. For public entities, the new standard is effective for annual and interim periods in fiscal years beginning after December 15, 2017. An entity may early adopt the standard but only at the beginning of an annual period for which it has not issued or made available for issuance financial statements (interim or annual). The Company is evaluating the effect that ASU 2016-16 will have on its consolidated financial statements and related disclosures.

In January 2017, FASB issued ASU No. 2017-01, "Business Combinations Clarifying the Definition of a Business" (Topic 805) ("ASU No. 2017-01"). ASU 2017-01 provides a framework to use in determining when a set of assets and activities is a business. ASU 2017-01 provides more consistency in applying the business combination guidance,

reduces the costs of application, and makes the definition of a business more operable. ASU 2017-01 is effective for interim and annual periods within those annual periods beginning after December 15, 2017. The Company is currently evaluating the impact ASU 2017-01 will have on the Company's results of operations, financial position and disclosures.

In March 2017, the FASB issued ASU No. 2017-07, Compensation Retirement Benefits (Topic 715): Improving the Presentation of Net Periodic Pension Cost and Net Periodic Postretirement Benefit Cost, an amendment of the FASB Accounting Standards Codification. This ASU requires employers that sponsor defined benefit pension and/or other post-retirement benefit plans to report the service cost component of net benefit cost in the same line item as other compensation costs arising from services rendered by the pertinent employees during the period. Employers are required to present the other components of net benefit costs in the income statement separately from the service cost component and outside a subtotal of income from operations. Additionally, only the service cost component of net periodic pension cost will be eligible for asset

capitalization. For public entities, the new standard is effective for annual periods beginning after December 15, 2017, including interim periods within that annual period. Early adoption is permitted as of the beginning of an annual period for which financial statements (interim or annual) have not been issued or made available for issuance. This ASU should be applied retrospectively for the presentation of the service cost component and the other components of net periodic pension cost and net periodic postretirement benefit cost in the income statement and prospectively, on and after the effective date, for the capitalization of the service cost component of net periodic pension cost and net periodic postretirement benefit in assets. The Company is evaluating the effect that ASU 2017-07 will have on its consolidated financial statements and related disclosures.

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

Forward-Looking Statements

The discussion below contains certain forward-looking statements including, but not limited to, among others, statements concerning future revenues and future business plans. Forward-looking statements include statements in which we use words such as “expect”, “believe”, “anticipate”, “intend”, “project”, “estimate”, “should”, “could”, “may”, “plan”, “predict”, “project”, “will”, “would” and similar expressions. Although we believe the expectations reflected in such forward-looking statements are based on reasonable assumptions, the forward-looking statements are subject to significant risks and uncertainties, and thus we cannot assure you that these expectations will prove to have been correct, and actual results may vary from those contained in such forward-looking statements. We discuss many of these risks and uncertainties in Item 1A under the heading “Risk Factors” in our Annual Report on Form 10-K for the fiscal year ended September 30, 2017. Factors that may cause such variances include, but are not limited to, our dependence on a small number of customers for a significant portion of our revenue, our high dependence on contracts with the U.S. federal government, our reliance in certain circumstances on single sources for supply of key product components, intense competition in the market segments in which we operate, and the recent changes in the U.S. Tax laws which are still under review by us. Given these uncertainties, you should not place undue reliance on these forward-looking statements. Also, forward-looking statements represent our estimates and assumptions only as of the date of this document. Except as required by law, we do not undertake any obligation to publicly update or revise any forward-looking statements contained in this report, whether as a result of new information, future events or otherwise. This management's discussion and analysis of financial condition and results of operations should be read in conjunction with our financial statements and the related notes included elsewhere in this filing and in our Annual Report on Form 10-K for the fiscal year ended September 30, 2017.

Critical Accounting Policies

Our discussion and analysis of our financial condition and results of operations are based upon our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses. On an on-going basis, we evaluate our estimates, including those related to uncollectible receivables, inventory valuation, impairment assessment of intangibles, income taxes, deferred compensation and retirement plans, as well as estimated selling prices used for revenue recognition and contingencies. We base our estimates on historical performance and on various other assumptions that we believe to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions. A description of our critical accounting policies is contained in our Annual Report on Form 10-K for the fiscal year ended September 30, 2017 in the “Critical Accounting Policies” section of Management's Discussion and Analysis of Financial Condition and Results of Operations.

Results of Operations

Overview of the three months ended December 31, 2017

Our revenues increased by approximately \$2.1 million, or 10%, to \$22.0 million for the three months ended December 31, 2017 as compared to \$19.9 million for the three months ended December 31, 2016. The increase in revenue is the result of an increase of \$2.4 million in our TS segment, partially offset by a \$0.3 million decrease in our HPP segment. Our gross margin percentage increased overall, from 22% of revenues for the three months ended December 31, 2016, to 23% for the three months ended December 31, 2017 due in part to an increase in higher margin

TS segment service revenues. Operating income increased by \$0.1 million from an operating loss of \$102 thousand for the three month period ended December 31, 2016 to operating income of \$7 thousand for the three month period ended December 31, 2017, primarily as a result of a \$681 thousand increase in gross profit partially offset by an increase of \$572 thousand in higher operating expenses. The increase in operating expenses was primarily the result of higher variable compensation costs, combined with increased costs for sales and engineering hires in our U.S and Germany divisions of the TS segment. Our income tax expense increased by approximately \$1.1 million to \$1.1 million for the three months ended December 31, 2017 as compared to an income tax benefit of \$15 thousand for the three months ended December 31, 2016. The increase to the income tax expense was primarily due to the Tax Cuts and Jobs Act which was enacted on December 22, 2017.

The following table details our results of operations in dollars and as a percentage of sales for the three months ended:

| | December 31, 2017 | % of sales | December 31, 2016 | % of sales |
|-------------------------------------|----------------------|------------------|----------------------|------------------|
| (Dollar amounts in thousands) | | | | |
| Total sales | \$21,999 | 100 % | \$ 19,916 | 100 % |
| Costs and expenses: | | | | |
| Cost of sales | 16,866 | 77 % | 15,464 | 78 % |
| Engineering and development | 698 | 3 % | 596 | 3 % |
| Selling, general and administrative | 4,428 | 20 % | 3,958 | 20 % |
| Total costs and expenses | 21,992 | 100 % | 20,018 | 101 % |
| Operating income (loss) | 7 | — % | (102) | (1)% |
| Other income (expense) | (105) | — % | 44 | — % |
| Loss before income taxes | (98) | — % | (58) | (1)% |
| Income tax expense (benefit) | 1,102 | 5 % | (15) | — % |
| Net loss | \$(1,200) | (5)% | \$ (43) | (1)% |

Revenues

Our revenues increased by approximately \$2.1 million to \$22.0 million for the three months ended December 31, 2017 as compared to \$19.9 million of revenues for the three months ended December 31, 2016. The TS segment revenues increase of \$2.4 million was partially offset by a \$0.3 million decrease in our HPP segment.

HPP segment revenue change was as follows for the three months ended December 31, 2017 and 2016:

| | 2017 | 2016 | Increase (decrease) \$ | % |
|-------------------------------|---------|---------|------------------------------|-------|
| (Dollar amounts in thousands) | | | | |
| Products | \$1,607 | \$1,527 | \$80 | 5 % |
| Services | 863 | 1,224 | (361) | (29)% |
| Total | \$2,470 | \$2,751 | \$(281) | (10)% |

The increase in HPP product revenues is primarily attributed to increased Myricom product shipments partially offset by lower Multicomputer product shipments and parts sales for the period. The decrease in HPP services revenues is primarily attributed to a \$329 thousand decrease in royalties on high-speed processing boards related to the E2D program shipped for the three months ended December 31, 2017 as compared to the three months ended December 31, 2016.

TS segment revenue change was as follows for the three months ended December 31, 2017 and 2016:

| | 2017 | 2016 | Increase \$ | % |
|-------------------------------|----------|----------|----------------|------|
| (Dollar amounts in thousands) | | | | |
| Products | \$14,036 | \$13,111 | \$925 | 7 % |
| Services | 5,493 | 4,054 | 1,439 | 35 % |
| Total | \$19,529 | \$17,165 | \$2,364 | 14 % |

The increase in TS segment product revenues of \$0.9 million during the period was primarily the result of an increase in product revenues of \$1.8 million in our U.K. division, partially offset by decreases of \$0.8 million and \$0.1 million in our U.S and German divisions, respectively. The \$1.8 million increase in the U.K. segment product revenues was primarily the result of increased product shipments to a major customer. The increase in TS segment service revenues of \$1.4 million during the period was primarily the result of increases of \$1.0 million, \$0.3 million and \$0.1 million of our U.S., German and U.K.

divisions, respectively. The \$1.0 million increase in the U.S. segment service revenues was primarily due to increases in third party maintenance revenues, internal/project revenues, and managed service provider revenues.

Our revenues by geographic area based on the customer location to which the products were shipped or services rendered were as follows for the three months ended December 31, 2017 and December 31, 2016:

| | 2017 | % | 2016 | % | Increase | |
|----------|-------------------------------|------|----------|------|----------|------|
| | | | | | \$ | % |
| | (Dollar amounts in thousands) | | | | | |
| Americas | \$13,233 | 60 % | \$13,123 | 66 % | \$110 | 1 % |
| Europe | 8,318 | 38 % | 6,497 | 33 % | 1,821 | 28 % |
| Asia | 448 | 2 % | 296 | 1 % | 152 | 51 % |
| Totals | \$21,999 | 100% | \$19,916 | 100% | \$2,083 | 10% |

The \$2.1 million increase in revenues is primarily attributed to increased revenues by our TS segment. The \$1.8 million increase in revenue to Europe is primarily the result of increased sales by our TS segment U.K. division to U.S. division multi-national customer.

Gross Margins

Our gross margin ("GM") increased by \$0.7 million to \$5.1 million for the three months ended December 31, 2017 as compared to a gross margin of \$4.5 million for the three months ended December 31, 2016. The GM as a percentage of revenue increased from 22% for the three months ended December 31, 2016 to 23% for the three months ended December 31, 2017 as follows:

| | 2017 | | 2016 | | Increase (decrease) | |
|-------|-------------------------------|------|---------|------|------------------------|-------|
| | GM\$ | GM% | GM\$ | GM% | GM\$ | GM% |
| | (Dollar amounts in thousands) | | | | | |
| HPP | \$1,462 | 59 % | \$1,760 | 64 % | \$(298) | (5) % |
| TS | 3,671 | 19 % | 2,692 | 16 % | 979 | 3 % |
| Total | \$5,133 | 23 % | \$4,452 | 22 % | \$681 | 1 % |

The impact of product mix within our HPP segment on gross margin for the period was as follows:

| | 2017 | | 2016 | | Increase (decrease) | |
|----------|-------------------------------|------|---------|------|------------------------|-------|
| | GM\$ | GM% | GM\$ | GM% | GM\$ | GM% |
| | (Dollar amounts in thousands) | | | | | |
| Products | \$616 | 38 % | \$612 | 40 % | \$4 | (2) % |
| Services | 846 | 98 % | 1,148 | 94 % | (302) | 4 % |
| Total | \$1,462 | 59 % | \$1,760 | 64 % | \$(298) | (5) % |

The overall HPP segment gross margin as a percentage of sales decreased to 59% for the period. The 5% decrease in gross margin as a percentage of sales in the HPP segment was primarily attributed to decreased high margin royalty revenues combined with the service and product mix.

The impact of product mix within our TS segment on gross margin for the three months ended December 31, 2017 and 2016 was as follows:

| | 2017 | | 2016 | | Increase | |
|----------|-------------------------------|------|---------|------|----------|-----|
| | GM\$ | GM% | GM\$ | GM% | GM\$ | GM% |
| | (Dollar amounts in thousands) | | | | | |
| Products | \$1,997 | 14 % | \$1,801 | 14 % | \$196 | —% |
| Services | 1,674 | 30 % | 891 | 22 % | 783 | 8 % |
| Total | \$3,671 | 19 % | \$2,692 | 16 % | \$979 | 3 % |

The overall TS segment gross margin as a percentage of sales increased to 19% for the three month period ended December 31, 2017 from 16% for the three month period ended December 31, 2016. The overall TS segment gross margin as a percentage of sales increase was primarily due to an 8% increase in service margins as a percentage of TS segment revenues, which is substantially due to having improved margins in our U.K. and Germany divisions.

Operating Expenses

Engineering and Development Expenses

The engineering and development expenses incurred by our HPP segment were \$0.7 million and \$0.6 million for the three months ended December 31, 2017 and 2016, respectively. The current period expenses were primarily for Myricom product engineering expenses incurred in connection with the development of the new Myricom ARIA security products. The increased engineering and development expenses for the three month period ended December 31, 2017 as compared to the three month period ended December 31, 2016 is primarily attributed to an increase in engineering headcount related expenses.

Selling, General and Administrative Expenses

The following table details our selling, general and administrative (“SG&A”) expense by operating segment for the three months ended December 31, 2017 and 2016:

| | For the three months ended December 31, | | | | | |
|-----------------------|--|---------------|---------|---------------|----------------|---------------|
| | 2017 | % of Total | 2016 | % of Total | \$ Increase | % Increase |
| | (Dollar amounts in thousands) | | | | | |
| By Operating Segment: | | | | | | |
| HPP segment | \$1,146 | 26 % | \$1,118 | 28 % | \$ 28 | 3 % |
| TS segment | 3,282 | 74 % | 2,840 | 72 % | 442 | 16 % |
| Total | \$4,428 | 100 % | \$3,958 | 100 % | \$ 470 | 12 % |

SG&A expenses increased by \$0.5 million, or 12%, for the three months ended December 31, 2017 as compared to the three months ended December 31, 2016. The increase in HPP segment SG&A expenses is primarily attributed to increased marketing costs related to the HPP security products. The increase in the TS segment SG&A expenses is primarily attributed to increases in variable compensation combined with increases for sales and engineering hires in our U.S and Germany operations.

Other Income/Expenses

The following table details our other income (expense) for the three months ended December 31, 2017 and 2016:

| | For the three months ended, | | |
|-----------------------------------|-----------------------------|-------------------|---------------------|
| | December 31, 2017 | December 31, 2016 | Increase (decrease) |
| | (Amounts in thousands) | | |
| Interest expense | \$(18) | \$ (19) | \$ 1 |
| Interest income | 5 | 4 | 1 |
| Foreign exchange gain (loss) | (93) | 54 | (147) |
| Other income, net | 1 | 5 | (4) |
| Total other income (expense), net | \$(105) | \$ 44 | \$ (149) |

The net change to other income (expenses) of \$149 thousand for the three months ended December 31, 2017 as compared to the three months ended December 31, 2016, was primarily driven by the net change of approximately \$(147) thousand in the foreign exchange gain (loss) on foreign currency holdings in the current period as compared to the prior year period.

Income Taxes

On December 22, 2017, the U.S. Tax Cuts and Jobs Act (H.R. 1) (the "Tax Act") was enacted into law. In accordance with ASC 740, Income Taxes, the Company is required to recognize the effect of the Tax Act in the period of enactment, which was the Company's first quarter of fiscal 2018 that ended on December 31, 2017. The many changes in the Tax Act include a permanent reduction in the maximum federal corporate income tax rate from 35% to 21% effective as of January 1, 2018. The statutory federal income tax rate applicable for the Company's fiscal year ending September 30, 2018 is expected to be 24.3% based on a fiscal year blended rate calculation.

The Company has made reasonable estimates of the impact of the Tax Act and, in accordance with the SEC's Staff Accounting Bulletin No. 118, has recorded a provisional net income tax expense of approximately \$1.1 million for the period ended December 31, 2017. The Company was required to revalue its U.S. deferred tax assets and liabilities to the new rate in the Company's first quarter of 2018. The Company has recorded a provisional estimate for a one-time tax expense of \$490 thousand, for the remeasurement of deferred tax assets and liabilities. The Tax Act also requires a mandatory deemed repatriation of undistributed foreign earnings and profits, at the rate of either 15.5% for cash or 8% for non-liquid assets. The Company has included a provisional estimate in the amount of \$649 thousand related to the one-time deemed repatriation transition tax on unrepatriated foreign earnings in the quarter ended December 31, 2017. As noted, these expenses have been recorded discretely in the quarter ending December 31, 2017. The provisional amount is based on information currently available, including estimated tax earnings and profits from foreign investments. The Company continues to gather and analyze information, including historical adjustments to earnings and profits of foreign subsidiaries, in order to complete the accounting for the effects of the estimated transition tax.

Our provision for income taxes for the three months ended December 31, 2017 was \$1.1 million. Our provision for income taxes for the three months ended December 31, 2016 was a tax benefit of \$15 thousand. The income tax provision for the current period is not comparable to the same period of the prior year due to the impact of the Tax Act, changes in pretax income over many jurisdictions, and the impact of discrete items. Generally, fluctuations in the effective tax rate are primarily due to changes in our geographic pretax income resulting from our business mix and changes in the tax impact of permanent differences, other special items, and other discrete tax items, which may have unique tax implications depending on the nature of the item.

Liquidity and Capital Resources

Our primary source of liquidity is our cash and cash equivalents, which increased by \$4.3 million to \$18.2 million as of December 31, 2017 from \$13.9 million as of September 30, 2017.

Significant sources of cash for the three months ended December 31, 2017 included a decrease in accounts receivable of \$7.4 million, an increase in accounts payable and accrued expenses of \$2.0 million, a decrease in deferred tax assets of \$0.5 million, and an increase in income taxes payable of \$0.4 million.

Significant uses of cash for the three months ended December 31, 2017 included an increase in other current assets of \$1.9 million, an increase in inventories of \$1.3 million, an increase in deferred costs of \$1.2 million, a net loss of \$1.2 million, and a decrease in deferred revenues of \$0.7 million.

Cash held by our foreign subsidiaries located in Germany and the United Kingdom totaled approximately \$5.8 million as of December 31, 2017 as compared to \$4.6 million as of September 30, 2017. This cash is included in our total cash and cash equivalents reported above.

If cash generated from operations is insufficient to satisfy working capital requirements, we may need to access funds through lines of credit, the equity markets, or other means. There is no assurance that we will be able to raise any such capital on terms acceptable to us, on a timely basis or at all. If we are unable to secure additional financing, we may not be able to complete the development or enhancement of our products, take advantage of future opportunities, respond to competition or continue to effectively operate our business.

Based on our current plans and business conditions, management believes that the Company's available cash and cash equivalents, the cash generated from operations and availability on our lines of credit will be sufficient to provide for the Company's working capital and capital expenditure requirements for the foreseeable future.

Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

The Company evaluated the effectiveness of the design and operation of our disclosure controls and procedures as of December 31, 2017. Our Chief Executive Officer, our Chief Financial Officer and other members of our senior management team supervised and participated in this evaluation. The term “disclosure controls and procedures,” as defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act, means controls and other procedures of a company that are designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the SEC's rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is accumulated and communicated to the company's management, including its principal executive and principal financial officers, as appropriate to allow timely decisions regarding required disclosure. Management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving their objectives and management necessarily applies its judgment in evaluating the cost-benefit relationship of possible controls and procedures. Based on the evaluation of our disclosure controls and procedures as of December 31, 2017, the Company's Chief Executive Officer and Chief Financial Officer concluded that, as of such date, our disclosure controls and procedures were not effective, due to the fact that we are not yet able to conclude that the material weakness described below in this Item 4 has been remediated by the changes we made in response to that material weakness.

As previously disclosed in Item 9A of our Annual Report on Form 10-K for the period ended September 30, 2017, our management identified a material weakness as of such date. A material weakness is a deficiency, or combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the Company's annual or interim financial statements will not be able to be prevented or detected in a timely basis. The identified material weakness is in connection with our controls over the revenue recognition process at our foreign subsidiaries, specifically whether revenue recognition criteria have been satisfied prior to recognizing revenue and the failure to sufficiently assess gross versus net revenue indicators to certain revenue transactions. We determined that controls over the revenue recognition process were not operating effectively and the resulting control gap amounted to a material weakness in our controls over financial reporting.

During the periods following our initial identification of the material weakness referred to above, management assessed various alternatives to remediate this material weakness and we implemented changes to our system of internal controls, which included the implementation of enhanced internal auditing procedures, whereby revenue transactions are subjected to an additional review process at the corporate level to ensure the correct accounting methodology is applied to all revenue transactions. During the three months ended December 31, 2017, management continued to take additional actions to upgrade our international accounting staff and improved accounting operations in our European divisions. Although we have implemented such changes to our internal controls over financial reporting as described above, at this time, we cannot conclude that the material weakness has been remediated and we will continue to make personnel changes and upgrade systems and processes throughout fiscal year 2018.

Changes in Internal Control over Financial Reporting.

During the three months ended December 31, 2017, management implemented process improvements and made certain changes to upgrade its internal accounting staff and improve operations in our European division in connection with the identified material weakness noted above. During the three months ended December 31, 2017, there were no other changes in our internal control over financial reporting that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II. OTHER INFORMATION

Item 6. Exhibits

Number Description

- 10.1* Executive Retention and Service Agreement with Victor Dellovo, dated September 4, 2012
- 10.2* Forms of Employee Restricted Stock Award Agreement
- 31.1* Rule 13(a)-14(a) / 15d-14(a) Certification of Chief Executive Officer
- 31.2* Rule 13(a)-14(a) / 15d-14(a) Certification of Chief Financial Officer
- 32.1* Section 1350 Certifications of Chief Executive Officer and Chief Financial Officer
Interactive Data Files regarding (a) our Consolidated Balance Sheets as of December 31, 2017 and September 30, 2017, (b) our Consolidated Statements of Income for the three months ended December 31, 2017 and 2016, (c) our Consolidated Statements of Comprehensive Income for the three months ended December 31, 2017 and 2016, (d) our Consolidated Statement of Shareholders' Equity for the three months ended December 31, 2017, (e) our Consolidated Statements of Cash Flows for the three months ended December 31, 2017 and 2016 and (f) the Notes to such Consolidated Financial Statements.
- 101*

*Filed Herewith

SIGNATURES

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

CSP INC.

Date: February 14, 2018 By: /s/ Victor Dellovo
Victor Dellovo
Chief Executive Officer,
President and Director

Date: February 14, 2018 By: /s/ Gary W. Levine
Gary W. Levine
Chief Financial Officer

Exhibit Index

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- 101*

*Filed Herewith