

AGILYSYS INC
Form 10-Q
January 30, 2019
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

(Mark One)

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended December 31, 2018

or

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from _____ to _____.

Commission file number 0-5734

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

Ohio 34-0907152
(State
or
other (I.R.S.
jurisdiction) employer
of Identification
incorporation)
or
organization)

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

(770) 810-7800

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(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 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, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer," and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer Accelerated filer

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

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

The number of Common Shares of the registrant outstanding as of January 25, 2019 was 23,535,117.

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AGILYSYS, INC.

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AGILYSYS, INC.
 CONDENSED CONSOLIDATED BALANCE SHEETS
 (Unaudited)

	December 31, 2018	March 31, 2018
(In thousands, except share data)		
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 36,995	\$39,943
Accounts receivable, net of allowance for doubtful accounts of \$839 and \$900, respectively	33,640	16,389
Contract assets	4,221	—
Inventories	1,566	1,999
Prepaid expenses and other current assets	4,334	5,593
Total current assets	80,756	63,924
Property and equipment, net	15,278	17,512
Goodwill	19,622	19,622
Intangible assets, net	8,450	8,484
Software development costs, net	37,812	45,181
Other non-current assets	5,515	2,484
Total assets	\$ 167,433	\$157,207
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	\$ 6,431	\$8,400
Contract liabilities	39,935	26,820
Accrued liabilities	12,872	9,241
Capital lease obligations, current	48	120
Total current liabilities	59,286	44,581
Deferred income taxes, non-current	523	227
Capital lease obligations, non-current	40	57
Other non-current liabilities	3,479	3,911
Commitments and contingencies (see Note 8)		
Shareholders' equity:		
Common shares, without par value, at \$0.30 stated value; 80,000,000 shares authorized; 31,606,831 shares issued; and 23,535,090 and 23,324,679 shares outstanding at December 31, 2018 and March 31, 2018, respectively	9,482	9,482
Treasury shares, 8,071,741 and 8,282,152 at December 31, 2018 and March 31, 2018, respectively	(2,422	) (2,486)
Capital in excess of stated value	639	(1,911)
Retained earnings	96,640	103,601
Accumulated other comprehensive loss	(234	) (255)
Total shareholders' equity	104,105	108,431
Total liabilities and shareholders' equity	\$ 167,433	\$157,207

See accompanying notes to condensed consolidated financial statements.

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

(In thousands, except share data)	Three months ended		Nine months ended	
	December 31,		December 31,	
	2018	2017	2018	2017
Net revenue:				
Products	\$10,232	\$8,156	\$28,081	\$25,758
Support, maintenance and subscription services	19,345	17,215	56,130	50,990
Professional services	6,437	5,939	20,013	18,557
Total net revenue	36,014	31,310	104,224	95,305
Cost of goods sold:				
Products (inclusive of developed technology amortization)	8,371	6,820	23,204	19,862
Support, maintenance and subscription services	3,909	4,132	11,960	12,610
Professional services	5,087	4,730	14,775	15,160
Total cost of goods sold	17,367	15,682	49,939	47,632
Gross profit	18,647	15,628	54,285	47,673
	51.8	% 49.9	% 52.1	% 50.0
Operating expenses:				
Product development	10,059	7,269	27,299	20,708
Sales and marketing	5,217	4,278	14,363	13,616
General and administrative	5,865	6,114	17,047	18,475
Depreciation of fixed assets	651	581	1,933	1,892
Amortization of intangibles	675	471	1,892	1,421
Restructuring, severance and other charges	58	378	948	1,241
Legal settlements	—	150	126	150
Total operating expense	22,525	19,241	63,608	57,503
Operating loss	(3,878)	(3,613)	(9,323)	(9,830)
Other expense (income):				
Interest (income)	(83)	(13)	(235)	(64)
Interest expense	3	3	8	7
Other expense (income), net	68	(46)	293	(196)
Loss before taxes	(3,866)	(3,557)	(9,389)	(9,577)
Income tax expense (benefit)	182	(1,623)	186	(1,439)
Net loss	\$(4,048)	\$(1,934)	\$(9,575)	\$(8,138)
Weighted average shares outstanding	23,048	22,851	23,030	22,777
Loss per share - basic and diluted:				
Loss per share	\$(0.18)	\$(0.08)	\$(0.42)	\$(0.36)

See accompanying notes to condensed consolidated financial statements.

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

(In thousands)	Three months ended December 31,		Nine months ended December 31,	
	2018	2017	2018	2017
Net loss	\$ (4,048)	\$ (1,934)	\$ (9,575)	\$ (8,138)
Other comprehensive gain/(loss), net of tax:				
Unrealized foreign currency translation adjustments	87	(17)	21	5
Total comprehensive loss	\$ (3,961)	\$ (1,951)	\$ (9,554)	\$ (8,133)

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,	
	2018	2017
Operating activities		
Net loss	\$(9,575)	\$(8,138)
Adjustments to reconcile net loss to net cash provided by operating activities		
Net restructuring, severance and other charges	(268)	262
Net legal settlements	—	150
Depreciation	1,933	1,892
Amortization	1,892	1,421
Amortization of developed technology	9,357	7,371
Deferred income taxes	44	(1,214)
Share-based compensation	2,956	3,776
Change in cash surrender value of company owned life insurance policies	12	11
Changes in operating assets and liabilities	(4,632)	(3,433)
Net cash provided by operating activities	1,719	2,098
Investing activities		
Capital expenditures	(1,610)	(5,289)
Capitalized software development costs	(2,189)	(7,272)
Investments in corporate-owned life insurance policies	(27)	(27)
Net cash used in investing activities	(3,826)	(12,588)
Financing activities		
Repurchase of common shares to satisfy employee tax withholding	(612)	(1,190)
Principal payments under long-term obligations	(90)	(92)
Net cash used in financing activities	(702)	(1,282)
Effect of exchange rate changes on cash	(139)	132
Net decrease in cash and cash equivalents	(2,948)	(11,640)
Cash and cash equivalents at beginning of period	\$39,943	\$49,255
Cash and cash equivalents at end of period	\$36,995	\$37,615

SUPPLEMENTAL SCHEDULE OF NON-CASH INVESTING ACTIVITIES:

Accrued capital expenditures	\$31	\$81
Accrued capitalized software development costs	—	107

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), payment gateway, reservation and table management, property management (PMS), inventory and procurement, business analytics, document management, guest offers 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 2019 refers to the fiscal year ending March 31, 2019.

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 Sheet as of December 31, 2018, as well as the Condensed Consolidated Statements of Operations, Condensed Consolidated Statements of Comprehensive Loss, and the Condensed Consolidated Statements of Cash Flows for the three and nine months ended December 31, 2018 and 2017, are unaudited. However, these financial statements have been prepared on the same basis as those in the audited annual financial statements, except for the recently adopted accounting pronouncements described below. 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, 2018, filed with the Securities and Exchange Commission (SEC) on May 25, 2018.

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, 2018, included in our Annual Report on Form 10-K. Our accounting policy for revenue recognition changed with the adoption of Accounting Standards Update ("ASU") No. 2014-09 ("Topic 606"), as described further below. There have been no other material changes to our significant accounting policies and estimates from those disclosed therein.

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Reclassification - Certain prior year balances have been reclassified to conform to the current year presentation. Specifically, we have elected to present our changes in operating assets and liabilities on the condensed consolidated statements of cash flows as a single line item. Prior year results have been condensed to be consistent with current year presentation.

Adopted and Recently Issued Accounting Pronouncements

In August 2018, the Financial Accounting Standards Board ("FASB") issued ASU No. 2018-15, Intangibles - Goodwill and Other - Internal-Use Software (Subtopic 350-40): Customer's Accounting for Implementation Costs Incurred in a Cloud Computing Arrangement That Is a Service Contract. ASU 2018-15 addresses the treatment of implementation costs incurred in a hosting arrangement that is a service contract. The update does not impact the accounting for the service element of a hosting arrangement that is a service contract. The update is effective for annual periods beginning after December 15, 2019, including interim periods within those annual periods, with early adoption (including early adoption in any interim period) permitted. We do not believe the adoption of this guidance will have a material impact on our consolidated financial statements.

In August 2018, the FASB issued ASU No. 2018-13, Fair Value Measurement (Topic 820): Disclosure Framework - Changes to the Disclosure Requirements for Fair Value Measurement. ASU 2018-13 addresses the required disclosures around fair value measurement. The disclosure requirements of the reasons for transfers between Level 1 and Level 2, the policy for timing transfers between levels, and the valuation process for Level 3 measurements have been removed. Certain modifications were made to required disclosures and additional requirements were established. The standard is effective for annual periods beginning after December 15, 2019, including interim periods within those annual periods. Early adoption is permitted. We do not believe the adoption of this guidance will have a material impact on our consolidated financial statements.

In July 2018, the FASB issued ASU No. 2018-11, Leases (Topic 842): Targeted Improvements and 2018-10, Codification Improvements to Topic 842, Leases. ASU 2018-11 provides for an additional optional adoption method of ASU 2016-02, Leases, allowing for the application of the new standard as of the adoption date and recognize a cumulative effect adjustment to the opening balance of retained earnings in the period of adoption. ASU 2018-10 provides corrections and updates to the previously issued codification regarding Topic 842. Various areas of the codification were impacted from the update. The two standards follow the effective dates of ASU 2016-02, Leases. Consistent with the documentation below, we are still assessing the impact of the adoption of ASU 2016-02, however we anticipate the adoption of the standard will materially affect our consolidated financial statements given the significance of our leases.

In February 2018, the FASB issued ASU No. 2018-02, Income Statement - Reporting Comprehensive Income (Topic 220). ASU 2018-02 addresses the effect of the change in the U.S. federal corporate tax rate on items within accumulated other comprehensive income or loss due to the enactment of the Tax Act on December 22, 2017. The new standard is effective for annual periods, and for interim periods within those annual periods beginning after December 15, 2018, with early adoption permitted. We do not believe the adoption of this guidance will have a material impact on our consolidated financial statements.

In January 2017, the 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. We have adopted this standard as of April 1, 2018; the adoption had no impact to our condensed consolidated financial statements. ASU No. 2017-04 eliminates Step 2 of the goodwill impairment test and requires 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.

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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. 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 have adopted this standard as of April 1, 2018; the adoption had no impact to our condensed consolidated financial statements.

In August 2016, the FASB issued ASU No. 2016-15, Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments, which provides guidance with the intent of reducing diversity in practice in how certain cash receipts and cash payments are presented and classified in the statement of cash flows. ASU No. 2016-15 is effective for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years with early adoption permitted, including adoption in an interim period. We have adopted this standard as of April 1, 2018; the adoption had no impact to our condensed consolidated financial statements.

In June 2016, the FASB issued ASU No. 2016-13, Financial Instruments - Credit Losses (Topic 326). This new standard changes the impairment model for most financial assets and certain other instruments. Entities will be required to use a model that will result in the earlier recognition of allowances for losses for trade and other receivables, held-to-maturity debt securities, loans, and other instruments. For available-for-sale debt securities with unrealized losses, the losses will be recognized as allowances rather than as reductions in the amortized cost of the securities. The new standard is effective for annual periods, and for interim periods within those annual periods, beginning after December 15, 2019, with early adoption permitted. We are currently reviewing this standard to assess the impact on our future consolidated financial statements.

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 we 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 requires entities to recognize revenue when control of the promised goods or services is transferred to customers at an amount that reflects the consideration to which the entity expects to be entitled to in exchange for those goods or services. We adopted ASU No. 2014-09 as of April 1, 2018 using the modified retrospective transition method. Please refer to Note 3, "Revenue Recognition" for further details.

3. Revenue Recognition

On April 1, 2018, we adopted ASU No. 2014-09, Revenue from Contracts with Customers (Topic 606), using the modified retrospective method applied to those contracts that were not completed as of the adoption date. Results for reporting periods beginning after the adoption date are presented under Topic 606, while prior period amounts are not adjusted and continue to be reported in accordance with our historic accounting under prior guidance.

Disaggregation of Revenue

We derive and report our revenue from the sale of products (software and hardware including server, storage, and point of sale), support, maintenance and subscription services and professional services. Revenue recognized at a point in time (products) totaled \$10.2 million and \$28.1 million, and over time (support, maintenance and subscription services and professional services) totaled \$25.8 million and \$76.1 million for the three and nine months ended December 31, 2018,

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respectively. See Nature of Goods and Services section below for additional information regarding revenue recognition procedures for our revenue streams.

Nature of Goods and Services

Our customary business practice is to enter into legally enforceable written contracts with our customers. The majority of our contracts are governed by a master agreement between us and the customer, which sets forth the general terms and conditions of any individual contract between the parties, which is then supplemented by a customer purchase order to specify the different goods and services, the associated prices, and any additional terms for an individual contract. Multiple contracts with a single counterparty entered into at the same time are evaluated to determine if the contracts should be combined and accounted for as a single contract.

Performance obligations promised in a contract are identified based on the goods or services that will be transferred to the customer that are both capable of being distinct and are distinct in the context of the contract. Capable of being distinct means the customer can benefit from the goods or services either on its own or together with other resources that are readily available from third parties or from us. Distinct in the context of the contract means the transfer of the goods or services is separately identifiable from other promises in the contract. The transaction price is determined based on the consideration to which we will be entitled and expect to receive in exchange for transferring goods or services to the customer. Typically, our contracts do not provide our customer with any right of return or refund; we do not constrain the contract price as it is probable that there will not be a significant revenue reversal due to a return or a refund.

Typically, our customer contracts contain one or more of the following goods or services which constitute performance obligations.

Our software licenses typically provide for a perpetual right to use our software. Generally, our contracts do not provide significant services of integration and customization and installation services are not required to be purchased directly from us. The software is delivered before related services are provided and is functional without professional services, updates and technical support. We have concluded that the software license is distinct as the customer can benefit from the software on its own. Software revenue is typically recognized when the software is delivered or made available for download to the customer.

Revenue for hardware sales is recognized when the product is shipped to the customer and when obligations that affect the customer's final acceptance of the arrangement have been fulfilled. A majority of our hardware sales involve shipment directly from its suppliers to the end-user customers. In these transactions, we are the primary obligor as we are responsible for negotiating price both with the supplier and the customer, payment to the supplier, establishing payment terms and product returns with the customer, and we bear the credit risk if the customer does not pay for the goods. As the principal contact with the customer, we recognize revenue and cost of goods sold when we are notified by the supplier that the product has been shipped. In certain limited instances, as shipping terms dictate, revenue is recognized upon receipt at the point of destination or upon installation at the customer site.

Support and maintenance revenue is derived from providing telephone and on-line technical support services, bug fixes, and unspecified software updates and upgrades to customers on a when-and-if-available basis. Each of these performance obligations provide benefit to the customer on a standalone basis and are distinct in the context of the contract. Each of these distinct performance obligations represent a stand ready obligation to provide service to a customer, which is concurrently delivered and has the same pattern of transfer to the customer, which is why we account for these support services as a single performance obligation, recognized over the term of the maintenance agreement.

Our subscription service revenue is comprised of fees for Software as a Service (“SaaS”) contracts that provide customers a right to access our software, which we maintain, and host in a data center, for a subscribed period. We do not provide the customer the contractual right to license the software outside of the data center at any time during the subscription period under these contracts. The customer can only benefit from the software and software maintenance when combined with the hosting service since the right to access is only provided to the software hosted in the data center. Accordingly, each of the rights to access the software, the maintenance services, and the hosting services is not considered a distinct

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performance obligation in the context of the contract and should be combined into a single performance obligation and recognized over the contract period. Typically, we invoice fees monthly.

Professional services revenues primarily consist of fees for consulting, installation, integration and training and are generally recognized over time as the customer simultaneously receives and consumes the benefits of the professional services as the services are being performed. Professional services that are billed on a time and materials basis are recognized over time as the services are performed. For contracts billed on a fixed price basis, revenue is recognized over time using an input method based on labor hours expended to date relative to the total labor hours expected to be required to satisfy the related performance obligation.

We estimate standalone selling price ("SSP") based on the price at which the performance obligations are sold by considering certain specific factors related to our company together with customer information. If the contract contains a single performance obligation, the entire transaction price is allocated to that performance obligation. Contracts that contain multiple performance obligations require an allocation of the transaction price to each performance obligation based on a relative SSP basis.

Shipping and handling fees billed to customers are recognized as revenue and the related costs are recognized in cost of goods sold. Revenue is recorded net of any applicable taxes collected and remitted to governmental agencies.

Contract Balances

Contract assets are rights to consideration in exchange for goods or services that we have transferred to a customer when that right is conditional on something other than the passage of time. The majority of our contract assets represent unbilled amounts related to professional services. We expect billing and collection of our contract assets to occur within the next twelve months. We receive payments from customers based upon contractual billing schedules and accounts receivable are recorded when the right to consideration becomes unconditional. Contract liabilities represent consideration received or consideration which is unconditionally due from customers prior to transferring goods or services to the customer under the terms of the contract.

Revenue recognized during the three and nine months ended December 31, 2018 from amounts included in contract liabilities at the beginning of the period was \$7.6 million and \$28.1 million. During the three and nine months ended December 31, 2018, we transferred \$0.4 million and \$3.8 million to accounts receivable from contract assets recognized at April 1, 2018 because the right to the transaction consideration became unconditional.

Our arrangements are for a period of one year or less. We had approximately \$42 million of remaining performance obligations as of December 31, 2018, which we expect to recognize over the next twelve months.

Assets Recognized from Costs to Obtain a Contract

We capitalize commission expenses paid to internal sales personnel as expenses that are incremental to obtaining customer contracts. We have determined that these commission expenses are in fact incremental and would not have occurred absent the customer contract. Capitalized sales commissions are amortized on a straight-line basis over the period the goods or services are expected to be transferred to the customer to which the assets relate, which can range as long as five years. We have determined that certain sales incentive programs meet the requirements to be capitalized. We have capitalized \$1.9 million of sales incentive costs in prior periods as part of our opening retained earnings adjustment on April 1, 2018. Capitalized sales incentive costs as of December 31, 2018 was \$2.9 million. These balances are included in other non-current assets on our condensed consolidated balance sheet and are amortized as we satisfy the underlying performance obligations, generally based on the contract terms and anticipated renewals. During the three and nine months ended December 31, 2018, we expensed \$1.3 million and \$3.1 million of

sales commissions, which includes amortization of capitalized amounts of \$0.3 million and \$0.8 million, respectively; included in operating expenses - sales and marketing in our condensed consolidated statement of operations. All other costs to obtain a contract are not considered incremental and therefore are expensed as incurred.

Financial Statement Impact of Adoption on Previously Reported Results

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We adopted Topic 606 using the modified retrospective method. The cumulative impact of applying the new guidance to all contracts with customers that were not completed as of April 1, 2018 was recorded as an adjustment to retained earnings as of the adoption date. As a result of applying the modified retrospective method to adopt the new standard, the following adjustments were made to noted accounts on the condensed consolidated balance sheet as of April 1, 2018:

(In thousands)	March 31, 2018	Adjustment from Topic 606	April 1, 2018
Assets:			
Accounts receivable, net	16,389	3,124	19,513
Contract assets	—	4,583	4,583
Prepaid expenses and other current assets	5,593	(496)	5,097
Other non-current assets	2,484	2,409	4,893
Liabilities:			
Contract liabilities	26,820	7,006	33,826
Shareholders' equity:			
Retained earnings	103,601	2,614	106,215

The acceleration of revenue that was deferred under prior guidance as of the adoption date was primarily attributable to the requirement of Topic 606 to allocate the transaction price to the performance obligations in the contract on a relative basis using SSP rather than allocating under the residual method, which allocates the entire arrangement discount to the delivered performance obligations.

Due to the Company's full valuation allowance as of the adoption date, there is no tax impact associated with the adoption of Topic 606.

We made certain presentation changes to our condensed consolidated balance sheet on April 1, 2018 to comply with Topic 606. Prior to adoption of the new standard, we offset accounts receivable and contract liabilities (previously presented as deferred revenue on our condensed consolidated balance sheet) for unpaid deferred performance obligations included in contract liabilities. Under the new standard, we record accounts receivable and related contract liabilities for non-cancelable contracts with customers when the right to consideration is unconditional. Upon adoption, the right to consideration in exchange for goods or services that have been transferred to a customer when that right is conditional on something other than the passage of time were reclassified from accounts receivable to contract assets.

Impact of Topic 606 on Financial Statement Line Items

The impact of adoption of Topic 606 on our condensed consolidated balance sheet as of December 31, 2018 and on our condensed consolidated statement of operations for the three and nine months ended December 31, 2018 was as follows:

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(In thousands)	December 31, 2018		
	As reported	Balance without adoption of Topic 606	Effect of Change Higher (Lower)
Assets:			
Accounts receivable, net	33,640	23,801	9,839
Contract assets	4,221	—	4,221
Prepaid expenses and other current assets	4,334	4,751	(417)
Other non-current assets	5,515	2,860	2,655
Liabilities:			
Contract liabilities	39,935	26,391	13,544
Shareholders' equity:			
Retained earnings	96,640	93,886	2,754
Three months ended December 31, 2018			
(In thousands)	As reported	Balance without adoption of Topic 606	Effect of Change Higher (Lower)
Net revenue:			
Products	10,232	9,889	343
Support, maintenance and subscription services	19,345	19,558	(213)
Professional services	6,437	6,699	(262)
Total net revenue:	36,014	36,146	(132)
Operating expenses:			
Sales and marketing	5,217	5,351	(134)
Net Loss	(4,048)	(4,050)	(2)
Nine months ended December 31, 2018			
(In thousands)	As reported	Balance without adoption of Topic 606	Effect of Change Higher (Lower)
Net revenue:			
Products	28,081	26,982	1,099
Support, maintenance and subscription services	56,130	56,752	(622)
Professional services	20,013	20,593	(580)
Total net revenue:	104,224	104,327	(103)

Operating expenses:				
Sales and marketing	14,363	14,606	(243)
Net Loss	(9,575	)(9,715	)(140)

The adoption of Topic 606 had no material impact to cash used in operating, investing or financing activities on our condensed consolidated statement of cash flows.

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4. 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 Plan

As of December 31, 2018, we had a remaining liability of approximately \$20,000 recorded for the fiscal 2018 restructuring plan.

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

(In thousands)	Balance at March 31, 2018	Provisions/Adjustments	Payments	Balance at December 31, 2018
Fiscal 2018 Restructuring Plan:				
Restructuring and other employment costs	\$ 198	\$	— \$ (178)	\$ 20
Total restructuring costs	\$ 198	\$	— \$ (178)	\$ 20

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5. Intangible Assets and Software Development Costs

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

(In thousands)	December 31, 2018			March 31, 2018		
	Gross carrying amount	Accumulated amortization	Net carrying amount	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	10,398	(10,398)	) —	10,398	(10,398)) —
Trade names	230	(180)	) 50	230	(146)	) 84
Patented technology	80	(80)	) —	80	(80)) —
	24,183	(24,133)	) 50	24,183	(24,099)	) 84
Unamortized intangible assets:						
Trade names	8,400	N/A	8,400	8,400	N/A	8,400
Total intangible assets	\$32,583	\$ (24,133)	) \$8,450	\$32,583	\$ (24,099)	) \$8,484
Software development costs						
Software development costs	\$67,541	\$ (29,729)	) \$37,812	\$53,368	\$ (20,372)	) \$32,996
Project expenditures not yet in use	—	—	—	12,185	—	12,185
Total software development costs	\$67,541	\$ (29,729)	) \$37,812	\$65,553	\$ (20,372)	) \$45,181

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,	
2019	\$ 3,257
2020	12,599
2021	12,515
2022	5,403
2023	3,399
2024	689
Total	\$ 37,862

Amortization expense for software development costs related to assets to be sold, leased, or otherwise marketed was \$3.4 million and \$2.6 million for the three months ended December 31, 2018 and 2017, and \$9.4 million and \$7.4 million for the nine months ended December 31, 2018 and 2017, respectively. These charges are included as costs of goods sold - products in our condensed consolidated statements of operations. Amortization expense relating to other definite-lived intangible assets was \$11,500 for the three months ended December 31, 2018 and 2017, and \$34,500 for the nine months ended December 31, 2018 and 2017. These charges are classified as operating expenses - amortization of intangibles in our 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 condensed consolidated balance sheets.

Capitalized software development costs for software internally developed to be sold, leased, or otherwise marketed, are carried on our balance sheet at carrying value, net of accumulated amortization. The Company did not capitalize any amounts for external-use software development costs during the three months ended December 31, 2018 due to

the current active projects which carry a sufficiently short amount of time between achieving technological feasibility and

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reaching general availability to preclude capitalization. We capitalized approximately \$1.6 million during the three months ended December 31, 2017, and \$2.0 million and \$6.5 million during the nine months ended December 31, 2018 and 2017, respectively.

6. Additional Balance Sheet Information

Additional information related to the condensed consolidated balance sheets is as follows:

(In thousands)	December 31, March 31,	
	2018	2018
Accrued liabilities:		
Salaries, wages, and related benefits	\$ 10,483	\$ 6,793
Other taxes payable	1,120	769
Restructuring liabilities	20	198
Severance liabilities	33	—
Professional fees	143	288
Deferred rent	430	407
Other	643	786
Total	\$ 12,872	\$ 9,241
Other non-current liabilities:		
Uncertain tax positions	\$ 1,342	\$ 1,519
Deferred rent	2,060	2,313
Other	77	79
Total	\$ 3,479	\$ 3,911

Accounts Receivable, net

Accounts receivable, net of allowance for doubtful accounts was \$33.6 million and \$16.4 million as of December 31, 2018 and March 31, 2018, respectively. The related allowance for doubtful accounts was \$0.8 million and \$0.9 million as of December 31, 2018 and March 31, 2018, respectively.

7. Income Taxes

The following table compares our income tax expense (benefit) and effective tax rates for the three and nine months ended December 31, 2018 and 2017:

(Dollars in thousands)	Three months		Nine months ended	
	ended		December 31,	
	December 31,	2017	2018	2017
Income tax expense (benefit)	\$182	\$(1,623)	\$186	\$(1,439)
Effective tax rate	(4.7)%	45.6 %	(2.0)%	15.0 %

For the three and nine months ended December 31, 2018, 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, adjustments to uncertain tax positions, a SAB 118 and Tax Act deferred tax adjustment including the ability to offset indefinite lived deferred tax liabilities with certain deferred tax assets, certain foreign and state tax effects, and other U.S. permanent book to tax differences.

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, 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.

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 staff of the Securities and Exchange Commission issued Staff Accounting Bulletin ("SAB") No. 118, which provides guidance on accounting for the tax effects of the Tax Act. SAB No. 118 allows registrants to record provisional amounts for a period up to one year from the date of enactment of the Tax Act when the registrant does not have the necessary information available, prepared, or analyzed (including computations) in reasonable detail to complete the accounting for certain income tax effects of the Tax Act. As of March 31, 2018, it was uncertain if and to what extent various states would enact legislation to conform to the Tax Act. As legislative guidance and accounting interpretations were expected in the future, we considered the accounting of the deferred tax remeasurement including the ability to offset indefinite lived deferred tax liabilities with certain deferred tax assets, to be incomplete and therefore only considered amounts related to these items to be reasonably estimated as of March 31, 2018. We completed the accounting for the Tax Act during Q3 fiscal 2019 and recorded an adjustment on December 31, 2018 of \$0.2 million to increase our deferred tax liability associated with certain indefinite lived intangibles.

8. 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. Ameranth 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 a patent 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.

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9. (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.

(In thousands, except per share data)	Three months ended		Nine months ended	
	December 31, 2018	2017	December 31, 2018	2017
Numerator:				
Net loss	\$(4,048)	\$(1,934)	\$(9,575)	\$(8,138)
Denominator:				
Weighted average shares outstanding	23,048	22,851	23,030	22,777
Loss per share - basic and diluted:				
Loss per share	\$(0.18)	\$(0.08)	\$(0.42)	\$(0.36)
Anti-dilutive stock options, SSARs, restricted shares and performance shares	1,471	1,658	1,443	1,705

Basic 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 482,846 and 530,138 of restricted shares at December 31, 2018 and 2017, respectively, as these shares were issued but were not vested and therefore, not considered outstanding for purposes of computing basic loss per share at the balance sheet dates.

Diluted 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.

10. 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 ("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 ("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.

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 model, which includes assumptions regarding the risk-free interest rate,

dividend yield, life of the award, and the volatility of our common shares.

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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)	2018	2017	2018	2017
Product development	\$509	\$456	\$938	\$982
Sales and marketing	136	173	335	529
General and administrative	637	829	1,683	2,265
Total share-based compensation expense	1,282	1,458	2,956	3,776

Stock-Settled 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, Inc.

The following table summarizes the activity during the nine months ended December 31, 2018 for SSARs awarded under the 2011 and 2016 Plans:

	Number of Rights	Weighted-Average Exercise Price	Remaining Contractual Term	Aggregate Intrinsic Value
(In thousands, except share and per share data)		(per right)	(in years)	
Outstanding at April 1, 2018	1,103,160	\$ 10.60		
Granted	158,244	14.22		
Exercised	(179,681)	10.28		
Forfeited	(43,960)	10.85		
Cancelled/expired	(6,138)	10.62		
Outstanding at December 31, 2018	1,031,625	\$ 11.20	5.0	\$ 2,155
Exercisable at December 31, 2018	576,277	\$ 10.60	4.5	\$ 2,155

As of December 31, 2018, total unrecognized stock based compensation expense related to non-vested SSARs was \$0.7 million, which is expected to be recognized over a weighted-average vesting period of 2.9 years.

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, 2018 for restricted shares awarded under the 2011 and 2016 Plans:

	Number of Shares	Weighted-Average Grant-Date Fair Value
(In thousands, except share and per share data)		(per share)
Outstanding at April 1, 2018	243,354	\$ 10.78
Granted	249,949	14.32
Vested	(10,000)	12.47
Forfeited	(63,748)	10.71
Outstanding at December 31, 2018	419,555	\$ 12.93

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, 2018, total unrecognized stock based compensation expense related to non-vested restricted stock was \$2.6 million, which is expected to be recognized over a weighted-average vesting period of 1.9 years.

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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 relative attainment of a 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, 2018 for the performance shares awarded under the 2016 Plan:

	Number of Shares
(In thousands, except share and per share data)	
Outstanding at April 1, 2018	91,463
Granted	63,291
Forfeited	(75,641)
Vested	(15,822)
Outstanding at December 31, 2018	63,291

Based on the performance goals, management estimates a liability of \$450,000 to be settled through the vesting of a variable number of the performance shares subsequent to March 31, 2019. As of December 31, 2018, total unrecognized stock based compensation expense related to non-vested performance shares was \$135,000, which is expected to be recognized over the remaining vesting period of 3 months.

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11. 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, 2018 and 2017.

The following tables present information about our financial assets 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 December 31, 2018 (Level 1)	Quoted prices in similar instruments and observable inputs (Level 2)	Active markets for unobservable inputs (Level 3)
(In thousands)			
Assets:			
Corporate-owned life insurance — non-current	\$ 868	—	\$ 868

	Fair value measurement used		
	Recorded value as of March 31, 2018 (Level 1)	Quoted prices in similar instruments and observable inputs (Level 2)	Active markets for unobservable inputs (Level 3)
(In thousands)			
Assets:			
Corporate-owned life insurance — non-current	\$ 853	—	\$ 853

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.

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

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	Nine months ended December 31,	
(In thousands)	2018	2017
Corporate-owned life insurance:		
Balance on April 1	\$853	\$809
Unrealized (loss) relating to instruments held at reporting date	(12)	(11)
Purchases, sales, issuances and settlements, net	27	27
Balance on December 31	\$868	\$825

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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, 2018, 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, 2018. 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 27 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, 2018 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), payment gateway, reservation and table management, property management (PMS), inventory and procurement, business analytics, document management, guest offers 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

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Growing revenue through international expansion

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

On April 1, 2018 we adopted ASU No. 2014-09, Revenue from Contracts with Customers (Topic 606), using the modified retrospective method applied to the contracts that were not completed as of the adoption date. Results for operating periods beginning after the adoption date are presented under Topic 606, while prior period amounts are not adjusted and continue to be reported in accordance with our historic accounting under prior guidance in effect at that time. For additional information regarding the adoption of this accounting standard, please refer to Note 3, "Revenue Recognition" in our condensed consolidated financial statements in Part I, Item I of this report for further details.

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:

- 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.

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Results of Operations

Third Fiscal Quarter 2019 Compared to Third Fiscal Quarter 2018

Net Revenue and Operating Loss

The following table presents our consolidated revenue and operating results for the three months ended December 31, 2018 and 2017:

	Three months ended		Increase	
	December 31,		(decrease)	
(Dollars in thousands)	2018	2017	\$	%
Net revenue:				
Products	\$10,232	\$8,156	\$2,076	25.5 %
Support, maintenance and subscription services	19,345	17,215	2,130	12.4
Professional services	6,437	5,939	498	8.4
Total net revenue	36,014	31,310	4,704	15.0
Cost of goods sold:				
Products (inclusive of developed technology amortization)	8,371	6,820	1,551	22.7
Support, maintenance and subscription services	3,909	4,132	(223)	(5.4)
Professional services	5,087	4,730	357	7.5
Total cost of goods sold	17,367	15,682	1,685	10.7
Gross profit	\$18,647	\$15,628	\$3,019	19.3 %
Gross profit margin	51.8 %	49.9 %		
Operating expenses:				
Product development	\$10,059	\$7,269	\$2,790	38.4 %
Sales and marketing	5,217	4,278	939	21.9
General and administrative	5,865	6,114	(249)	(4.1)
Depreciation of fixed assets	651	581	70	12.0
Amortization of intangibles	675	471	204	43.3
Restructuring, severance and other charges	58	378	(320)	(84.7)
Legal settlements	—	150	(150)	nm
Operating loss	\$(3,878)	\$(3,613)	\$(265)	7.3 %
Operating loss percentage	(10.8)%	(11.5)%		

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, 2018		2017	
Net revenue:				
Products	28.4	%	26.0	%
Support, maintenance and subscription services	53.7		55.0	
Professional services	17.9		19.0	
Total	100.0	%	100.0	%
Cost of goods sold:				
Products (inclusive of developed technology amortization)	23.2	%	21.8	%
Support, maintenance and subscription services	10.9		13.2	
Professional services	14.1		15.1	
Total	48.2	%	50.1	%
Gross profit	51.8	%	49.9	%
Operating expenses:				
Product development	27.9	%	23.2	%
Sales and marketing	14.5		13.6	
General and administrative	16.3		19.5	
Depreciation of fixed assets	1.8		1.9	
Amortization of intangibles	1.9		1.5	
Restructuring, severance and other charges	0.2		1.2	
Legal settlements	—		0.5	
Operating loss	(10.8)	%	(11.5)	%

Net revenue. Total net revenue increased \$4.7 million, or 15.0%, during the third quarter of fiscal 2019 compared to the third quarter of fiscal 2018. Products revenue increased \$2.1 million, or 25.5%, due to growth in both third party hardware sales and proprietary on premise software sales, both of which grew more than 20% compared to the prior year. Support, maintenance and subscription services revenue increased \$2.1 million, or 12.4%, compared to the third quarter of fiscal 2018 driven by growth in customers using our on premise software products which require the payment of support and maintenance along with continued increases in subscription based service revenue, which increased approximately 25% during the third quarter of fiscal 2019 compared to the third quarter of fiscal 2018. Professional services revenue increased \$0.5 million, or 8.4%, as a result of growth in our customer base including installations of our traditional on premise and subscription based software solutions and increased use of our technical services team for customer specific software development projects.

Gross profit and gross profit margin. Our total gross profit increased \$3.0 million, or 19.3%, for the third quarter of fiscal 2019 and total gross profit margin increased 1.9% to 51.8% from 49.9%. Products gross profit increased \$0.5 million and gross profit margin increased 1.8% to 18.2% primarily due to higher proprietary on premise software sales. Support, maintenance and subscription services gross profit increased \$2.4 million and gross margin increased 3.8% to 79.8% due primarily to the scalable nature of our infrastructure supporting and hosting customers. Professional services gross profit increased \$0.1 million and gross profit margin increased 0.6% to 21.0% due to increased revenue with a relatively consistent increase in cost.

Operating expenses

Operating expenses, excluding the charges for legal settlements, restructuring, severance and other charges, increased \$3.8 million, or 20.1%, during the third quarter of fiscal 2019 compared with the third quarter of fiscal 2018.

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Product development. Product development increased \$2.8 million, or 38.4%, in the third quarter of fiscal 2019 due primarily to the absence of cost capitalization. The products in our rGuest platform for which we had capitalized costs reached general availability by the beginning of the second quarter of fiscal 2019. These products join our well established products with the application of agile development practices in a more dynamic development process that involves higher frequency releases of product features and functions. The Company did not capitalize any amounts for external-use software development costs during the third quarter of fiscal 2019 due to the relatively short development cycle associated with the agile development of our current active products. We capitalized approximately \$2.1 million in total development costs during the three months ended December 31, 2017. Total product development costs, including operating expenses and capitalized amounts, were \$10.1 million in the third quarter of fiscal 2019 compared to \$9.4 million in the third quarter of fiscal 2018. The \$0.7 million increase is mostly due to the continued expansion of our R&D teams.

Sales and marketing. Sales and marketing increased by \$0.9 million, or 21.9%, in the third quarter of fiscal 2019 compared with the third quarter of fiscal 2018 due primarily to a \$0.5 million increase in commissions and incentive compensation as well as \$0.3 million of increased advertising and promotional expense related to the timing of marketing events.

General and administrative. General and administrative decreased \$0.2 million, or 4.1%, in the third quarter of fiscal 2019 compared with the third quarter of fiscal 2018 mostly due to a \$0.2 million reduction in stock compensation for executive grants.

Restructuring, severance, and other charges. Restructuring, severance, and other charges decreased \$0.3 million during the third quarter of fiscal 2019 compared to the third quarter of fiscal 2018 due to the non-recurring nature of the 2018 restructuring activities.

Other Expenses (Income)

	Three months ended		December 31, 2017	
(Dollars in thousands)	2018	2017	(\$)	(%)
Other expense (income):				
Interest (income)	\$(83)	\$(13)	\$70	nm
Interest expense	3	3	—	— %
Other expense (income), net	68	(46)	(114)	nm
Total other (income), net	\$(12)	\$(56)	\$(44)	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 expense (income). Other expense (income) consists mainly of the impact of foreign currency due to movement of European and Asian currencies against the US dollar.

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Income Taxes

	Three months ended		(Unfavorable)	
	December 31,		favorable	
(Dollars in thousands)	2018	2017	\$	%
Income tax expense (benefit)	\$182	\$(1,623)	\$(1,805)	nm
Effective tax rate	(4.7)%	45.6 %		

nm - not meaningful

For the three months ended December 31, 2018, 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, adjustments to uncertain tax positions, a SAB 118 and Tax Act deferred tax adjustment including the ability to offset indefinite lived deferred tax liabilities with certain deferred tax assets, certain foreign and state tax effects, and other U.S. permanent book to tax differences.

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.

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 \$0.2 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.

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.

Results of Operations

First Nine Months Fiscal 2019 Compared to First Nine Months Fiscal 2018

Net Revenue and Operating Loss

The following table presents our consolidated revenue and operating results for the nine months ended December 31, 2018 and 2017:

(Dollars in thousands)	Nine months ended		Increase	
	December 31,		(decrease)	
	2018	2017	\$	%
Net revenue:				
Products	\$28,081	\$25,758	\$2,323	9.0 %
Support, maintenance and subscription services	56,130	50,990	5,140	10.1
Professional services	20,013	18,557	1,456	7.8
Total net revenue	104,224	95,305	8,919	9.4
Cost of goods sold:				
Products (inclusive of developed technology amortization)	23,204	19,862	3,342	16.8
Support, maintenance and subscription services	11,960	12,610	(650)	(5.2)
Professional services	14,775	15,160	(385)	(2.5)
Total cost of goods sold	49,939	47,632	2,307	4.8
Gross profit	\$54,285	\$47,673	\$6,612	13.9 %
Gross profit margin	52.1 %	50.0 %		
Operating expenses:				
Product development	\$27,299	\$20,708	\$6,591	31.8 %
Sales and marketing	14,363	13,616	747	5.5
General and administrative	17,047	18,475	(1,428)	(7.7)
Depreciation of fixed assets	1,933	1,892	41	2.2
Amortization of intangibles	1,892	1,421	471	33.1
Restructuring, severance and other charges	948	1,241	(293)	(23.6)
Legal settlements	126	150	(24)	(16.0)
Operating loss	\$(9,323)	\$(9,830)	\$507	(5.2)%
Operating loss percentage	(8.9)%	(10.3)%		
nm - not meaningful				

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, 2018		2017	
Net revenue:				
Products	26.9	%	27.0	%
Support, maintenance and subscription services	53.9		53.5	
Professional services	19.2		19.5	
Total	100.0	%	100.0	%
Cost of goods sold:				
Products (inclusive of developed technology amortization)	22.3	%	20.9	%
Support, maintenance and subscription services	11.4		13.2	
Professional services	14.2		15.9	
Total	47.9	%	50.0	%
Gross profit	52.1	%	50.0	%
Operating expenses:				
Product development	26.2	%	21.7	%
Sales and marketing	13.8		14.3	
General and administrative	16.3		19.4	
Depreciation of fixed assets	1.9		2.0	
Amortization of intangibles	1.8		1.5	
Restructuring, severance and other charges	0.9		1.3	
Legal settlements	0.1		0.2	
Operating loss	(8.9	)%	(10.3)%

Net revenue. Total net revenue increased \$8.9 million, or 9.4%, during the first nine months of fiscal 2019 compared to the first nine months of fiscal 2018. Products revenue increased \$2.3 million, or 9.0%, due to growth in both third party hardware sales and proprietary on premise software sales. Support, maintenance and subscription services revenue increased \$5.1 million, or 10.1%, compared to the first nine months of fiscal 2018 driven by growth in customers using our on premise software products which require the payment of support and maintenance along with continued increases in subscription based service revenue, which increased approximately 23.6% during the first nine months of fiscal 2019 compared to the first nine months of fiscal 2018. Professional services revenue increased \$1.5 million, or 7.8%, as a result of growth in our customer base including installations of our traditional on premise and subscription based software solutions and increased use of our technical services team for customer specific software development projects.

Gross profit and gross profit margin. Our total gross profit increased \$6.6 million, or 13.9%, for the first nine months of fiscal 2019 and total gross profit margin increased 2.1% to 52.1% from 50.0%. Products gross profit decreased \$1.0 million and gross profit margin decreased approximately 5.5% to 17.4% primarily as a result of increased developed technology amortization. Support, maintenance and subscription services gross profit increased \$5.8 million and gross margin increased 3.4% to 78.7% due primarily to the scalable nature of our infrastructure supporting and hosting customers. Professional services gross profit increased \$1.8 million and gross profit margin increased 7.9% to 26.2% due to increased revenue with lower cost from restructuring of our professional services workforce during the first quarter of 2018 into a more efficient operating structure with more limited use of contract labor.

Operating expenses

Operating expenses, excluding the charges for legal settlements, restructuring, severance and other charges, increased \$6.4 million, or 11.4%, during the first nine months of fiscal 2019 compared with the first nine months of fiscal 2018.

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Product development. Product development increased \$6.6 million, or 31.8%, in the first nine months of fiscal 2019 compared to the first nine months of fiscal 2018 due primarily to a reduction in the amount of cost capitalization. The products in our rGuest platform for which we had capitalized costs reached general availability by the beginning of the second quarter of fiscal 2019. These products join our well established products with the application of agile development practices in a more dynamic development process that involves higher frequency releases of product features and functions. The Company capitalized \$2.0 million of external use software development costs, and \$0.3 million of internal use software development costs in the nine months ended December 31, 2018, with the full balance capitalized in Q1 fiscal 2019. We capitalized approximately \$8.2 million in total development costs during the nine months ended December 31, 2017. Total product development costs, including operating expenses and capitalized amounts, were \$29.6 million in the first nine months of fiscal 2019 compared to \$28.9 million in the first nine months of fiscal 2018. The \$0.7 million increase is mostly due to the continued expansion of our R&D teams.

Sales and marketing. Sales and marketing increased \$0.7 million, or 5.5%, in the first nine months of fiscal 2019 compared with the first nine months of fiscal 2018 mostly due to increased commissions and incentive compensation as a result of our continued revenue growth.

General and administrative. General and administrative decreased \$1.4 million, or 7.7%, in the first nine months of fiscal 2019 compared with the first nine months of fiscal 2018 due to approximately \$1.1 million reduction in professional and outside services costs and a \$0.2 million reduction in compensation expense.

Restructuring, severance, and other charges. Restructuring, severance, and other charges during the first nine months of fiscal 2019 compared to the first nine months of fiscal 2018 decreased \$0.3 million, or 23.6% due to non-recurring 2018 restructuring activities.

Other Expenses (Income)

	Nine months ended		(Unfavorable)	
	December 31, 2018	December 31, 2017	favorable	
(Dollars in thousands)	2018	2017	\$	%
Other expense (income):				
Interest (income)	\$(235)	\$(64)	\$171	nm
Interest expense	8	7	(1)	(14.3)%
Other expense (income), net	293	(196)	(489)	nm
Total other expense (income), net	\$66	\$(253)	\$(319)	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 expense (income). Other expense (income) consists mainly of the impact of foreign currency due to movement of European and Asian currencies against the US dollar.

Income Taxes

	Nine months ended			
	December 31,		(Unfavorable) favorable	
(Dollars in thousands)	2018	2017	\$	%
Income tax expense (benefit)	\$186	\$(1,439)	\$(1,625)	nm
Effective tax rate	(2.0)%	15.0 %		

nm - not meaningful

For the nine months ended December 31, 2018, 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, adjustments to uncertain tax positions, a SAB 118 and Tax Act deferred tax adjustment including the ability to offset indefinite lived deferred tax liabilities with certain deferred tax assets, certain foreign and state tax effects, and other U.S. permanent book to tax differences.

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.

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 \$0.2 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.

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 \$37.0 million as of December 31, 2018 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, 2018 and March 31, 2018, our total debt was approximately \$0.1 million and \$0.2 million, comprised of capital lease obligations in both periods.

At December 31, 2018, 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 90% 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	
	2018	2017
Net cash provided by (used in):		
Operating activities	\$1,719	\$2,098
Investing activities	(3,826)	(12,588)
Financing activities	(702)	(1,282)
Effect of exchange rate changes on cash	(139)	132
Net decrease in cash and cash equivalents	\$(2,948)	\$(11,640)

Cash flow provided by operating activities. Cash flow provided by operating activities during the first nine months of fiscal 2018 excluded approximately \$7.3 million of capitalized software development costs which were reflected in investing activities. Cash flow provided by operating activities during the first nine months of fiscal 2019 excluded approximately \$2.2 million of capitalized software development costs which were reflected in investing activities. This reduction is related to a change in development and deployment practices that no longer permit capitalization of such costs. This results in the inclusion of this type of cost in operating activities rather than investing activities and is the main driver of decreased cash provided by operating activities during the current fiscal year.

Cash flow used in investing activities. For the first nine months of fiscal 2019, the \$3.8 million in cash used in investing activities was comprised of \$2.2 million for the development of proprietary software and \$1.6 million for purchase of property and equipment compared to \$7.3 million and \$5.3 million, respectively, in fiscal 2018. The reduction in expenditures associated with development of proprietary software is described above under cash flow provided by operating activities. The reduction in expenditures associated with property and equipment is due to payments associated with the establishment of our India Development Center in fiscal 2018, as well as reduced capitalization of internal use software and reduced equipment purchases in fiscal 2019.

Cash flow used in financing activities. During the first nine months of fiscal 2019, the \$0.7 million used in financing activities was primarily comprised of \$0.6 million related to the repurchase of shares to satisfy employee tax withholding on share based compensation. The reduction from fiscal 2018 is primarily related to the repurchase of shares to satisfy employee tax withholding associated with the timing of vesting of grants in fiscal 2018.

Contractual Obligations

As of December 31, 2018, there were no significant changes to our contractual obligations as presented in our Annual Report for the year ended March 31, 2018.

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, 2018. There have been no material changes in our significant accounting policies and estimates since March 31, 2018 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. These statements are not guarantees of future performance and involve risks, uncertainties, and assumptions that are difficult to predict. These statements are based on management's current expectations, intentions, or beliefs and are subject to a number of factors, assumptions, and uncertainties that could cause actual results to differ materially from those described in the forward-looking statements. Factors that could cause or contribute to such differences or that might otherwise impact the business include 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, 2018. We undertake no obligation to update any such factor or to publicly announce the results of any revisions to any forward-looking statements contained herein 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, 2018. There have been no material changes in our market risk exposures since March 31, 2018.

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, 2018 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.

The following materials from our quarterly report on Form 10-Q for the quarter ended December 31, 2018, formatted in XBRL (Extensible Business Reporting Language): (i) Condensed Consolidated Balance Sheets at December 31, 2018 and March 31, 2018, (ii) Condensed Consolidated Statements of Operations for the three and nine months ended December 31, 2018 and 2017, (iii) Condensed Consolidated Statements of Comprehensive Loss for the three and nine months ended December 31, 2018 and 2017, (iv) Condensed Consolidated Statements of Cash Flows for the nine months ended December 31, 2018 and 2017, and (v) Notes to Condensed Consolidated Financial Statements for the three and nine months ended December 31, 2018.

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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 30, 2019 /s/ Anthony S. Pritchett
Anthony S. Pritchett
Chief Financial Officer
(Principal Financial Officer and Duly Authorized Officer)