CSP INC /MA/
Form 10-Q
February 13, 2019

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

FORM 10-Q

x	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
o	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 x No o.

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

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. (Check one)

Large accelerated filer	o	Accelerated filer	o
Non-accelerated filer	x	Smaller reporting company	x

Emerging growth company o
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. o
Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes o No x
As of February 12, 2019, the registrant had 4,117,831 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, 2018 (Unaudited)	September 30, 2018
ASSETS		
Current assets:		
Cash and cash equivalents	$ 20,656	$ 25,107
Accounts receivable, net of allowances of $89 and $87	17,208	11,980
Unbilled accounts receivable	—	1,166
Investment in lease, net-current portion	258	246
Inventories	6,790	7,558
Refundable income taxes	476	480
Other current assets	2,318	1,878
Total current assets	47,706	48,415
Property, equipment and improvements, net	979	847
Other assets:		
Intangibles, net	43	48
Investment in lease, net-less current portion	495	564
Deferred income taxes	1,837	1,895
Cash surrender value of life insurance	3,469	3,441
Other assets	66	65
Total other assets	5,910	6,013
Total assets	$ 54,595	$ 55,275
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities:		
Accounts payable and accrued expenses	$ 12,844	$ 12,524
Deferred revenue	738	1,197
Pension and retirement plans	336	340
Total current liabilities	13,918	14,061
Pension and retirement plans	5,999	6,168
Income taxes payable	694	709
Other noncurrent liabilities	565	535
Total liabilities	21,176	21,473
Commitments and contingencies		
Shareholders' equity:		
Common stock, $.01 par value per share; authorized, 7,500 shares; issued and outstanding 4,018 and 4,017 shares, respectively	41	40
Additional paid-in capital	14,842	14,661
Retained earnings	29,531	29,926
Accumulated other comprehensive loss	(10,995)	(10,825)

Total shareholders’ equity	33,419	33,802
Total liabilities and shareholders’ equity	$ 54,595	$ 55,275

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, 2018	December 31, 2017
Sales:		
Product	$15,711	$ 13,669
Services	3,269	2,961
Total sales	18,980	16,630
Cost of sales:		
Product	13,212	11,280
Services	1,419	987
Total cost of sales	14,631	12,267
Gross profit	4,349	4,363
Operating expenses:		
Engineering and development	745	698
Selling, general and administrative	3,589	3,500
Total operating expenses	4,334	4,198
Operating income	15	165
Other income (expense):		
Foreign exchange gain (loss)	7	(68)
Other income (expense), net	30	61
Total other income (expense)	37	(7)
Income before income taxes	52	158
Income tax expense	2	1,153
Net income (loss) from continuing operations	50	(995)
Net loss from discontinued operations, net of tax	—	(205)
Net income (loss)	50	(1,200)
Net income (loss) attributable to common stockholders	$48	$ (1,200)
Net income (loss) from continuing operations per share – basic	$0.01	$ (0.26)
Net loss from discontinued operations per share – basic	$—	$ (0.06)
Net income (loss) per share - basic	$0.01	$ (0.32)
Weighted average shares outstanding – basic	3,868	3,768
Net income (loss) from continuing operations per share – diluted	$0.01	$ (0.26)
Net loss from discontinued operations per share – diluted	$—	$ (0.06)
Net income (loss) per share - diluted	$0.01	$ (0.32)
Weighted average shares outstanding – diluted	3,966	3,768

See accompanying notes to unaudited consolidated financial statements.

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

	For the three months ended	
	December 31, 2018	December 31, 2017
Net income (loss)	$50	$ (1,200)
Other comprehensive loss:		
Foreign currency translation loss adjustments	(170)	(4)
Other comprehensive loss	(170)	(4)
Total comprehensive loss	$(120)	$ (1,204)

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, 2018:
(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, 2018	4,017	$ 40	$ 14,661	$ 29,926	$ (10,825)	$ 33,802
Adoption of ASU 2014-09 (see note 12)	—	—	—	158	—	158
Net income	—	—	—	50	—	50
Other comprehensive loss	—	—	—	—	(170)	(170)
Exercise of stock options	1	1	3	—	—	4
Stock-based compensation	—	—	178	—	—	178
Cash dividends declared on common stock ($0.15 per share)	—	—	—	(603)	—	(603)
Balance as of December 31, 2018	4,018	$ 41	$ 14,842	$ 29,531	$ (10,995)	$ 33,419

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, 2018	December 31, 2017
Cash flows provided by (used in) operating activities:		
Net income (loss)	$ 50	$ (1,200)
Loss from discontinued operations, net of income tax benefit	—	(205)
Net income (loss) from continuing operations	50	(995)
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:		
Depreciation and amortization	101	94
Amortization of intangibles	5	30
Loss on sale of fixed assets, net	—	4
Foreign exchange (gain) loss	(7)	68
Non-cash changes in accounts receivable	2	—
Non-cash changes in inventories	125	128
Stock-based compensation expense on stock options and restricted stock awards	178	121
Deferred income taxes	(99)	490
Increase in cash surrender value of life insurance	(28)	(29)
Changes in operating assets and liabilities:		
(Increase) decrease in accounts receivable	(4,128)	6,826
Decrease in life insurance receivable	256	—
(Increase) decrease in inventories	629	(955)
Increase in deferred costs	—	(6)
Decrease in refundable income taxes	109	32
Increase in other current assets	(703)	(494)
Decrease in investment in lease	57	—
Decrease in accounts payable and accrued expenses	(269)	(2,671)
Increase (decrease) in deferred revenue	(247)	109
Decrease in pension and retirement plans liabilities	(78)	(30)
Increase (decrease) in income taxes payable	(13)	647
Increase in other long term liabilities	101	2
Net cash provided by (used in) operating activities of continuing operations	(3,959)	3,371
Net cash provided by operating activities of discontinued operations	—	1,183
Net cash provided by (used in) operating activities	(3,959)	4,554
Cash flows used in investing activities:		
Life insurance premiums paid	—	(66)
Purchases of property, equipment and improvements	(233)	(44)
Net cash used in investing activities of continuing operations	(233)	(110)
Net cash used in investing activities of discontinued operations	—	(65)
Net cash used in investing activities	(233)	(175)
Cash flows provided by (used in) financing activities:		
Principal payments on capital leases	(70)	—
Proceeds from issuance of shares under equity compensation plans	3	9
Net cash provided by (used in) financing activities	(67)	9
Effects of exchange rate on cash	(192)	(83)
Net increase (decrease) in cash and cash equivalents	(4,451)	4,305

Cash and cash equivalents of continuing operations, beginning of period	25,107	10,421
Cash and cash equivalents of discontinued operations, beginning of period	—	3,464
Cash and cash equivalents, beginning of period	25,107	13,885
Cash and cash equivalents, end of period	20,656	18,190
Less: Cash and cash equivalents of discontinued operations at end of period	—	4,685
Cash and cash equivalents of continuing operations at end of period	$20,656	$ 13,505
Supplementary cash flow information:		
Cash paid for income taxes	$—	$ 95
Cash paid for interest	$67	$ 72
Non-cash accrual of dividend payable	$603	$ 437

See accompanying notes to unaudited consolidated financial statements.

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CSP INC. AND SUBSIDIARIES
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS
FOR THE THREE MONTHS ENDED DECEMBER, 2018 AND 2017

Organization and Business

CSP Inc. ("CSPi" or "CSPI" or "the Company" or "we" or "our") was incorporated in 1968 and is based in Lowell, Massachusetts. CSPi and its subsidiaries develop and market IT integration solutions, advanced security products, managed IT services, purpose built network adapters, and high-performance cluster computer systems to meet the diverse requirements of its commercial and defense customers worldwide. 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, 2018.

Unless otherwise noted, discussion within these notes to the consolidated financial statements relates to continuing operations. Refer to Note 13 for additional information on discontinued operations.

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, and the calculation of standalone selling price 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. Revenue

Effective October 1, 2018, the Company adopted 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. See Note 12 for effects of initial adoption. This note reflects the accounting policy change for revenue starting on the date of adoption.

We derive revenue from the sale of integrated hardware and software, third-party service contracts, professional services, managed services, financing of hardware and software, and other services.

We recognize revenue from hardware upon transfer of control, which is at a point in time typically upon shipment when title transfers. Revenue from software is recognized at a point in time when the license is granted.

We recognize revenue from third-party service contracts as either gross sales or net sales depending on whether the Company is acting as a principal party to the transaction or simply acting as an agent or broker based on control and timing. The Company is a principal if it controls the good or service before that good or service is transferred to the customer. We record revenue as gross when the Company is a principal party to the arrangement and net of cost when we are acting as a broker or agent. Under gross sales recognition, the entire selling price is recorded in revenue and our cost to the third-party service provider or vendor is recorded in cost of goods sold. Under net sales recognition, the cost to the third-party service provider or vendor is recorded as a reduction to revenue resulting in net sales equal to the gross profit on the transaction. Third-party service contracts are sold in different combinations with hardware, software, and services. We have determined the third-party services contracts are a single performance obligation in each sale. When the Company is an agent, revenue is typically recorded at a point in time. When the Company is the principal, revenue is recognized over the contract term.

Professional services generally include implementation, installation, and training services. Professional services are considered a series of distinct services that form one performance obligation and revenue is recognized over time as services are performed.

Revenue generated from managed services is recognized over the term of the contract. Certain managed services contracts include financing of hardware and software. Revenues from arrangements which include financing are allocated considering relative standalone selling prices of lease and non-lease components within the agreement. The lease components include the hardware and software, which are subject to ASC 840. The non-lease component includes the managed services and is subject to ASC 606.

Other services generally include revenue generated through our royalty, extended warranty, multicomputer repair, and maintenance contracts. Royalty revenue is sales-based and recognized on date of subsequent sale of the product, which occurs on date of customer shipment. Revenue from extended warranty contracts is recognized evenly over the period of the warranty. Multicomputer repair services revenue is recognized upon control transfer when the customer takes possession of the computer at time of shipping. Revenue generated from maintenance services is recognized evenly over the term of the contract.

Variable consideration is immaterial. Any products sold with right to return exists with the manufacturer. Managed service contracts contain the right to refund if canceled within 30 days of inception. Any products with a standard warranty are treated as a warranty obligation under ASC 460, Guarantees.

The following policies are applicable to our major categories of segment revenue transactions:

HPP Segment Revenue

HPP segment revenue is derived from the sale of integrated hardware and software, maintenance, and other services through the Multicomputer and Myricom product lines.

Myricom revenue is derived from the sale of products, which are comprised of both hardware and embedded software which is essential to the products functionality, and post contract maintenance and support. Post contract maintenance and support is considered immaterial in the context of the contract and therefore is not a separate performance obligation.

TS Segment Revenue

TS Segment revenue is derived from the sale of hardware, software, professional services, third-party service contracts, maintenance contracts, managed services, and financing of hardware and software. Financing revenue is recognized in accordance with ASC 840, Leases. Financing revenue is recorded in revenue as equipment leasing and is part of the Company's central operations.

Third-party service contracts are evaluated to determine whether such service revenue should be recorded as gross sales or net and whether over time or at point in time.

See disaggregated revenues below by products/services and geography.

For the three months ended December 31,	High Performance Products Segment	Technology Solutions Segment			Consolidated Total
		United Kingdom	U.S.	Total	
	(Amounts in thousands)				
2018					
Sales:					
Product	$1,733	$ 1,732	$12,209	$13,941	$ 15,674
Service	293	70	2,906	2,976	3,269
Finance *	—	—	37	37	37
Total sales	$2,026	$ 1,802	$15,152	$16,954	$ 18,980

* Finance revenue is related to equipment leasing and is not subject to the guidance on revenue from contracts with customers.

Significant Judgments

The input method using labor hours expended relative to the total expected hours is used to recognize revenue for professional services. Only the hours that depict the Company's performance toward satisfying a performance obligation are used for progress. An estimate for professional services is made at the beginning of each contract based on prior experience and monitored throughout the services. This method is most appropriate as it depicts the measure of progress towards satisfaction of the performance obligation.

When product and services are sold together, the allocation of the transaction price to each performance obligation is calculated using a budgeted cost-plus margin approach. Due to the complex nature of these contracts, there is significant judgment in allocating the transaction price. These estimates are periodically reviewed by project managers, engineers, and other staff involved to ensure estimates are appropriate. For items sold separately, including hardware, software, professional services, maintenance contracts, other services, and third-party service contracts, there is no allocation performed as there is one performance obligation.

Contract Assets and Liabilities

When the Company has performed work but does not have an unconditional right to payment, a contract asset is recorded. When the Company has the right to bill a customer, accounts receivable is recorded as an unconditional right exists. Current contract assets were $646 thousand and $1.2 million as of December 31, 2018 and October 1, 2018, respectively. The current portion is recorded in other current assets on the consolidated balance sheets. There were no non-current contract assets as of December 31, 2018 and October 1, 2018. Contract assets that became unconditional during the period ended December 31, 2018 and reclassified as a receivable were $918 thousand.

Contract liabilities arise when payment is received before the Company transfers a good or service to the customer. Current contract liabilities were $738 thousand and $1.1 million as of December 31, 2018 and October 1, 2018, respectively. The current portion is recorded in deferred revenue on the consolidated balance sheets. There were no non-current contract liabilities as of December 31, 2018 and October 1, 2018, respectively. Revenue recognized in the first quarter of fiscal 2019 that was included in contract liabilities as of the beginning of the period was $1.6 million.

Contract Costs

Incremental costs of obtaining a contract involving customer transactions where the revenue and the related transfer of goods and services are less than a one-year period, are expensed as incurred, utilizing the practical expedient in ASC 340-40-25-4. For a period greater than one year, incremental contract costs are capitalized if the Company expects to recover these costs. These costs are only capitalized if the contract is obtained. The costs are amortized over the contract term and expected renewal periods. The period of amortization is generally three to six years. Incremental costs are related to commissions in the TS portion of the business. Current capitalized contract costs are within the account other current assets on the consolidated balance sheets for the periods ended December 31, 2018 and September 30, 2018. The portion of current capitalized costs was $48 thousand and $71 thousand as of December 31, 2018 and October 1, 2018, respectively. There are no non-current capitalized costs on the consolidated balance sheets. The amount of incremental costs amortized for the three months ended December 31, 2018 was $52 thousand, which is recorded in selling, general, and administrative expenses. There was no impairment related to incremental costs capitalized.

Costs to fulfill a contract are capitalized when the costs are related to a contract or anticipated contract, generate or enhance resources that will be used in satisfying performance obligations in the future, and costs are recoverable. Costs to fulfill a contract are related to the TS portion of the business and involve activities performed before managed services can be completed. Current capitalized fulfillment costs are within the account other current assets on the consolidated balance sheets. The portion of current capitalized costs was $59 thousand and $56 thousand as of December 31, 2018 and October 1, 2018, respectively. There are no non-current capitalized fulfillment costs on the consolidated balance sheets. The amount of fulfillment costs amortized for the three months ended December 31, 2018 was $3 thousand, which is recorded in cost of sales. There was no impairment related to fulfillment costs capitalized.

Other

Projects are typically billed upon completion or at certain milestones. Product and services are typically billed when shipped or as services are being performed. Payment terms are typically 30 days to pay in full except in Europe where it could be up to 90 days. Most of the Company’s contracts are less than one year. As a practical expedient, the Company has elected not to adjust the amount of consideration for effects of a significant financing component when it is anticipated the promised good or service will be transferred and the subsequent payment will be one year or less. The Company elected to use the optional exemption to not disclose the aggregate amount of the transaction price allocated to performance obligations that have an original expected duration of one year or less. This is due to a low amount of performance obligations less than one year being unsatisfied at each period end. Most of these contracts are related to product sales.

The Company has certain contracts that have an original term of more than one year. The royalty agreement is longer than one year and managed service contracts are longer than one year. For these contracts the aggregate amount of the transaction price allocated to the performance obligations that are unsatisfied or partially unsatisfied as of December 31, 2018 is $6.3 million. This revenue is expected to be recognized over 5 years and relates mainly to managed service contracts.

4. Earnings Per Share of Common Stock

Basic net income (loss) per common share is computed by dividing net income (loss) available to common shareholders by the weighted average number of common shares outstanding for the period. Diluted net income (loss) 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 (loss) 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 (loss) attributable to common stockholders are as follows:

	For the three months ended

	December 31, 2018	December 31, 2017
	(Amounts in thousands except per share data)	
Income (loss) from continuing operations	$50	$(995)
Loss from discontinued operations	—	(205)
Net income (loss)	50	(1,200)
Less: net income attributable to nonvested common stock	2	—
Net income (loss) attributable to common stockholders	$48	$(1,200)
Weighted average total shares outstanding – basic	4,018	3,768
Less: weighted average non-vested shares outstanding	150	—
Weighted average number of common shares outstanding – basic	3,868	3,768
Potential common shares from non-vested stock awards and the assumed exercise of stock options	98	—
Weighted average common shares outstanding – diluted	3,966	3,768
Net income (loss) from continuing operations per share – basic	$0.01	$(0.26)
Net loss from discontinued operations per share – basic	$—	$(0.06)
Net income (loss) share – basic	$0.01	$(0.32)
Net income (loss) from continuing operations per share – diluted	$0.01	$(0.26)
Net loss from discontinued operations per share – diluted	$—	$(0.06)
Net income (loss) per share – diluted	$0.01	$(0.32)

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

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5. Inventories

Inventories consist of the following:

	December 31, 2018	September 30, 2018
	(Amounts in thousands)	
Raw materials	$898	$ 1,098
Work-in-process	280	226
Finished goods	5,612	6,234
Total	$6,790	