

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended March 31, 2019

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

For the transition period from _____ to _____

Commission file number 000-27507

CYNERGISTEK, INC.

(Exact name of registrant as specified in its charter)

Delaware
(State or other jurisdiction of
incorporation or organization)

37-1867101
(I.R.S. Employer
Identification No.)

11940 Jollyville Road, Suite 300-N
Austin, Texas 78759

(Address of principal executive offices, zip code)

(949) 614-0700

(Issuer's telephone number)

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 .

Indicated by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Date 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.

Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller reporting company

Emerging growth company

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

Securities registered pursuant to Section 12(b) of the Act:

Title of Each Class	Trading Symbol(s)	Name of Each Exchange on Which Registered
Common Shares, \$.001 par value	CTEK	NYSE American

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 standard provided pursuant to Section 13(a) of the Exchange Act.

The number of shares of the issuer's common stock, \$0.001 par value, outstanding as of May 13, 2019, was 9,773,521.

CYNERGISTEK, INC.
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PART I – FINANCIAL INFORMATION
ITEM 1. FINANCIAL STATEMENTS.

CYNERGISTEK, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEETS

	March 31, 2019	December 31, 2018
	(unaudited)	
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 12,386,637	\$ 6,571,381
Accounts receivable, net	4,309,391	5,572,467
Prepaid and other current assets	3,763,872	1,425,858
Refundable income taxes	-	472,059
Current assets held for sale	-	8,427,408
Total current assets	20,459,900	22,469,173
Property and equipment, net	848,131	887,874
Deposits	79,710	87,778
Deferred income taxes	1,615,173	2,146,020
Intangible assets, net	8,637,255	9,089,989
Goodwill	17,008,189	17,008,189
Noncurrent assets held for sale	-	1,844,349
Total assets	\$ 48,648,358	\$ 53,533,372
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable and accrued expenses	\$ 362,770	\$ 1,370,336
Accrued compensation and benefits	1,393,890	1,592,765
Deferred revenue	1,262,627	918,165
Income taxes payable	4,840,746	-
Note payable	-	343,750
Current portion of long-term liabilities	839,590	3,271,052
Current liabilities held for sale	138,894	7,299,561
Total current liabilities	8,838,517	14,795,629
Long-term liabilities:		
Term loan, less current portion	-	12,851,617
Promissory notes to related parties, less current portion	1,125,000	5,015,625
Capital lease obligations, less current portion	-	1,570
Operating lease liability, less current portion	355,031	436,805
Noncurrent liabilities held for sale	-	58,967
Total long-term liabilities	1,480,031	18,364,584
Commitments and contingencies		
Stockholders' equity:		
Common stock, par value at \$0.001, 33,333,333 shares authorized, 9,723,065 shares issued and outstanding at March 31, 2019, and 9,630,050 shares issued and outstanding at December 31, 2018	9,723	9,630
Additional paid-in capital	32,319,958	31,910,831
Accumulated earnings (deficit)	6,000,129	(11,547,302)
Total stockholders' equity	38,329,810	20,373,159
Total liabilities and stockholders' equity	\$ 48,648,358	\$ 53,533,372

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

CYNERGISTEK, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(UNAUDITED)

	Three Months Ended March 31,	
	2019	2018
Net revenues	\$ 5,773,657	\$ 4,374,569
Cost of revenues	3,484,639	2,408,780
Gross profit	2,289,018	1,965,789
Operating expenses:		
Sales and marketing	1,481,383	1,367,871
General and administrative expenses	1,653,633	2,169,291
Depreciation	38,985	35,064
Amortization of acquisition-related intangibles	452,734	452,734
Total operating expenses	3,626,735	4,024,960
Loss from operations	(1,337,717)	(2,059,171)
Other income (expense):		
Other income	8	20
Interest expense	(295,905)	(399,733)
Total other income (expense)	(295,897)	(399,713)
(Loss) before provision for income taxes	(1,633,613)	(2,458,884)
Income tax benefit	144,214	602,472
Net loss from continuing operations	(1,489,399)	(1,856,412)
Income from discontinued operations, including gain on sale, net of tax	19,036,830	1,149,069
Net income (loss)	\$ 17,547,431	\$ (707,343)
Net income (loss) per share:		
From continuing operations:		
Basic	\$ (0.15)	\$ (0.19)
Diluted	\$ (0.15)	\$ (0.19)
From discontinued operations:		
Basic	\$ 1.97	\$ 0.12
Diluted	\$ 1.92	\$ 0.12
Net income:		
Basic	\$ 1.81	\$ (0.07)
Diluted	\$ 1.77	\$ (0.07)
Number of weighted average shares outstanding:		
Basic	9,673,689	9,586,608
Diluted	9,931,048	9,586,608

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

CYNERGISTEK, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY
THREE MONTHS ENDED MARCH 31, 2019 AND 2018
(UNAUDITED)

	Common Stock		Additional	Accumulated	Total
	Shares	Amount	Paid-in Capital	(Deficit) Earnings	Stockholders' Equity
Balance at December 31, 2017	9,576,028	\$ 9,576	\$ 31,156,362	\$ (14,320,560)	\$ 16,846,378
Stock compensation expense for options and warrants granted to employees and directors	-	-	11,516	-	11,516
Stock compensation expense for restricted stock units granted to employees	-	-	176,746	-	176,746
Stock options exercised	16,519	17	(17)	-	-
Cumulative effect of adoption of revenue recognition standard ASC 606	-	-	-	879,666	879,666
Net loss	-	-	-	(707,343)	(707,343)
Balance at March 31, 2018	<u>9,592,547</u>	<u>\$ 9,593</u>	<u>\$ 31,344,607</u>	<u>\$ (14,148,237)</u>	<u>\$ 17,205,963</u>

	Common Stock		Additional	Accumulated	Total
	Shares	Amount	Paid-in Capital	(Deficit) Earnings	Stockholders' Equity
Balance at December 31, 2018	9,630,050	\$ 9,630	\$ 31,910,831	\$ (11,547,302)	\$ 20,373,159
Stock compensation expense for options and warrants granted to employees and directors	-	-	11,286	-	11,286
Stock compensation expense for restricted stock units granted to employees	-	-	395,406	-	395,406
Restricted stock units exercised	70,000	70	(70)	-	-
Stock options exercised	23,015	23	2,505	-	2,528
Net income	-	-	-	17,547,431	17,547,431
Balance at March 31, 2019	<u>9,723,065</u>	<u>\$ 9,723</u>	<u>\$ 32,319,958</u>	<u>\$ 6,000,129</u>	<u>\$ 38,329,810</u>

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

CYNERGISTEK, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(UNAUDITED)

	Three Months Ended March 31,	
	2019	2018
Cash flows from operating activities:		
Net income (loss)	\$ 17,547,431	\$ (707,343)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Depreciation	75,620	91,583
Amortization of intangible assets	452,734	452,734
Deferred income taxes	530,847	(230,000)
Bad debt recoveries	-	(13,469)
Stock compensation expense for warrants and options granted to employees and directors	11,286	11,516
Stock compensation expense for restricted stock units granted to employees and directors	395,406	176,746
Note payable issued in consideration for severance pay	-	343,750
Interest expense related to loan acquisition costs	85,883	1,617
Gain on sale of discontinued operations before income taxes	(23,839,119)	-
Changes in operating assets and liabilities:		
Accounts receivable	77,110	2,700,505
Supplies	75,252	70,244
Prepaid and other current assets	1,316,130	(153,185)
Deposits	8,068	(402)
Accounts payable and accrued expenses	71,861	(709,915)
Income taxes payable	5,312,805	-
Accrued compensation and benefits	(1,325,793)	(996,077)
Deferred revenue	<u>353,309</u>	<u>(390,351)</u>
Net cash provided by operating activities	<u>1,148,830</u>	<u>647,953</u>
Cash flows from investing activities:		
Proceeds from sale of net assets of discontinued operations	24,370,254	-
Purchases of property and equipment	<u>(49,185)</u>	<u>(26,275)</u>
Net cash provided by (used for) investing activities	<u>24,321,069</u>	<u>(26,275)</u>
Cash flows from financing activities:		
Proceeds from term loan	-	17,250,000
Loan acquisition fees paid	-	(111,250)
Payments on term loans	(15,401,786)	(11,818,333)
Payments on promissory notes to related parties	(4,234,375)	(6,750,000)
Payments on capital leases	(21,010)	(34,862)
Proceeds from issuance of common stock through stock options and warrants	<u>2,528</u>	<u>-</u>
Net cash used for financing activities	<u>(19,654,643)</u>	<u>(1,464,445)</u>
Net increase (decrease) in cash and cash equivalents	5,815,256	(842,767)
Cash and cash equivalents, beginning of period	<u>6,571,381</u>	<u>4,252,060</u>
Cash and cash equivalents, end of period	<u>\$ 12,386,637</u>	<u>\$ 3,409,293</u>

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

CYNERGISTEK, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (CONTINUED)
(UNAUDITED)

	Three Months Ended March 31,	
	2019	2018
Supplemental disclosure of cash flow information:		
Interest paid	\$ 496,489	\$ 644,895
Income taxes (refunded) paid	\$ (5,409)	\$ 20,262
Non-cash investing and financing activities:		
Capitalized right-to-use asset resulted from the adoption of ASC 842	\$ -	\$ 808,841
Capitalized operating lease liability resulted from the adoption of ASC 842	\$ -	\$ 683,797

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

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
THREE MONTHS ENDED MARCH 31, 2019 AND 2018
(UNAUDITED)

1. BASIS OF PRESENTATION

The accompanying unaudited condensed consolidated financial statements of CynergisTek, Inc. and its subsidiaries (the “Company”, “we”, “us” or “CynergisTek”) have been prepared in accordance with generally accepted accounting principles of the United States of America (“GAAP”) for interim financial statements pursuant to the rules and regulations of the Securities and Exchange Commission. Accordingly, these financial statements do not include all of the information and notes required by GAAP for complete financial statements. These unaudited condensed consolidated financial statements should be read in conjunction with the audited consolidated financial statements and notes thereto included in our Annual Report on Form 10-K for the fiscal year ended December 31, 2018, as filed with the Securities and Exchange Commission (“SEC”) on March 27, 2019.

The unaudited condensed consolidated financial statements included herein reflect all adjustments (which include only normal, recurring adjustments) that are, in the opinion of management, necessary to state fairly our financial position and results of operations as of and for the periods presented. The results for such periods are not necessarily indicative of the results to be expected for the full year.

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, the 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. As a result, actual results could differ from those estimates.

The accompanying unaudited condensed consolidated financial statements include the accounts of CynergisTek and its wholly owned subsidiaries. All intercompany balances and transactions have been eliminated.

Based on our integration strategies, and an analysis of how our Chief Operating Decision Makers review, manage and are compensated, we have determined that the Company operates as one segment. As described in Note 17, we sold the MPS business on March 20, 2019. For the periods presented, all revenues were derived from domestic operations.

We have performed an evaluation of subsequent events through the date of filing these unaudited condensed consolidated financial statements with the SEC.

Certain balances have been reclassified to conform to current period presentation.

2. RECENTLY ISSUED ACCOUNTING PRONOUNCEMENTS

Recently Adopted Accounting Pronouncements

In February 2016, the Financial Accounting Standards Board (“FASB”) issued a new accounting standard on leasing. The new standard requires companies to record most leased assets and liabilities on the balance sheet, and also proposed a dual model for recognizing expense. The Company adopted the standard as of January 1, 2019, with retroactive reporting for prior periods (the comparative option). Adoption of the new standard resulted in the recording of operating lease right-of-use (“ROU”) assets and operating lease liabilities of \$808,841 and \$683,797, respectively, as of January 1, 2018, with the difference due to deferred rent that were reclassified to the ROU asset value. The standard did not affect our consolidated net income or cash flows. See Note 6 for further details.

In August 2016, the FASB issued a new accounting standard which is intended to reduce the existing diversity in practice in how certain cash receipts and cash payments are classified in the statement of cash flows. This guidance was effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years with early adoption permitted, provided that all of the amendments are adopted in the same period. Adoption of these accounting changes did not have a material impact on our consolidated financial statements.

In January 2017, the FASB issued a new accounting standard which 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. This guidance was effective for the Company beginning in 2019. Adoption of these accounting changes did not have a material impact on our consolidated financial statements.

In January 2017, the FASB issued a new accounting standard simplifying the test for goodwill impairment. Currently, the fair value of the reporting unit is compared with the carrying value of the reporting unit (identified as "Step 1"). If the fair value of the reporting unit is lower than its carrying amount, then the implied fair value of goodwill is calculated. If the implied fair value of goodwill is lower than the carrying value of goodwill an impairment is recognized (identified as "Step 2"). The new standard eliminates Step 2 from the impairment test; therefore, a goodwill impairment will be recognized as the difference of the fair value and the carrying value. The new standard becomes effective on January 1, 2020, with early adoption permitted. We adopted this standard on January 1, 2019. This new standard has no impact on our financial position, results of operations and cash flows.

In May 2017, the FASB issued a new accounting standard which provides guidance about which changes to the terms or conditions of a share-based payment award require an entity to apply modification accounting in ASC Topic 718. Under the new guidance, modification accounting is required only if the fair value, the vesting conditions, or the classification of the award (as equity or liability) changes as a result of the change in terms or conditions. This guidance is effective for the Company beginning in 2019. Adoption of these accounting changes did not have a material impact on our consolidated financial statements.

In June 2018, the FASB issued a new accounting standard which provides guidance that expands the scope of Topic 718 to include share-based payment transactions for acquiring goods and services from nonemployees. The new guidance is effective for the Company beginning in 2019, with early adoption permitted. Adoption of these accounting changes did not have a material impact on our consolidated financial statements.

Recently Issued Accounting Pronouncements Not Yet Adopted

In August 2018, the FASB issued a new accounting standard which modifies the disclosure requirements on fair value measurements. This guidance will be effective for fiscal years beginning after December 15, 2019. The amendments related to the range and weighted average of significant unobservable inputs used to develop Level 3 fair value measurements, and the narrative description of measurement uncertainty should be applied prospectively. All other amendments should be applied retrospectively. An entity is permitted to early adopt any removed or modified disclosures upon issuance of this guidance and delay adoption of the additional disclosures until their effective date. We do not anticipate adoption to have a material impact on our consolidated financial statements.

3. ACCOUNTS RECEIVABLE

A summary of accounts receivable is as follows:

	<u>March 31, 2019</u>	<u>December 31, 2018</u>
Trade receivables	\$ 4,309,391	\$ 5,572,467
Allowance for doubtful accounts	-	-
Total accounts receivable, net	<u>\$ 4,309,391</u>	<u>\$ 5,572,467</u>

4. DEFERRED COMMISSIONS

Our incremental costs of obtaining a contract, which consist of sales commissions, are deferred and amortized over the period of contract performance. Effective January 1, 2018, we adopted the modified retrospective method of the new revenue recognition pronouncement. Deferred commissions are included in prepaid and other current assets in our consolidated balance sheets. We had \$991,766 and \$849,975 of unamortized deferred commissions as of March 31, 2019 and 2018, respectively. We had \$256,553 and \$47,030 of commissions expense for the three months ended March 31, 2019 and 2018, respectively.

5. PROPERTY AND EQUIPMENT

A summary of property and equipment follows:

	March 31, 2019	December 31, 2018
Furniture and fixtures	\$ 195,586	\$ 316,926
Computers and office equipment	604,147	563,857
Right of use assets	683,797	683,797
Property and equipment at cost	1,483,530	1,443,240
Less accumulated depreciation and amortization	(635,399)	(555,365)
	<u>\$ 848,131</u>	<u>\$ 887,874</u>

6. LEASES

We lease approximately 17,000 square feet of office space at 27271 Las Ramblas, Suite 200, Mission Viejo, California. This lease terminates in April 2021. During the first quarter of 2019, we subleased this space to two subtenants. The terms of these subleases end concurrently with the end of our lease obligation in April 2021. We also lease approximately 3,600 square feet of office space at 11410 Jollyville Road, Suite 2201, Austin, Texas. This lease terminates in September 2019. During the first quarter of 2018, we subleased this space to a subtenant. The terms of this sublease ends concurrently with the end of our lease obligation in September 2019. We also lease approximately 9,600 square feet of office space at 11940 Jollyville Road, Austin, Texas. This lease terminates in May 31, 2020. Operating lease expense totaled \$158,642 and \$184,482 for the three months ended March 31, 2019 and 2018, respectively.

We used a discount rate of 5.5% as of January 1, 2018 in determining our operating lease liability. This rate represented our incremental borrowing rate at that time. Short-term leases with initial terms of twelve months or less are not capitalized.

We also lease certain office equipment under a finance lease arrangement.

Maturities of lease liabilities are as follows:

	Operating Leases	Finance Leases
2019	\$ 468,402	\$ 1,013
2020	512,632	-
2021	132,926	-
Total lease payments	1,113,960	1,013
Less imputed interest	(479,287)	(19)
Total	<u>\$ 634,673</u>	<u>\$ 994</u>

7. INTANGIBLE ASSETS

Intangible assets are amortized over expected useful lives ranging from 1.5 to 10 years and consist of the following:

	March 31, 2019			December 31, 2018		
	Carrying Amount	Accumulated Amortization	Net Book Value	Carrying Amount	Accumulated Amortization	Net Book Value
Acquired technology	\$ 9,220,608	\$ (2,426,485)	\$ 6,794,123	\$ 9,220,608	\$ (2,202,291)	\$ 7,018,317
Customer relationships	2,933,257	(1,992,632)	940,625	2,933,257	(1,858,257)	1,075,000
Trademarks	1,693,978	(841,478)	852,500	1,693,978	(763,978)	930,000
Non-compete agreements	264,243	(214,236)	50,007	264,243	(197,571)	66,672
Total	\$ 14,112,086	\$ (5,474,831)	\$ 8,637,255	\$ 14,112,086	\$ (5,022,097)	\$ 9,089,989

8. DEFERRED REVENUE

We record deferred revenues when amounts are billed to customers in advance of our performance. During the three months ended March 31, 2019 and 2018, \$335,569 and \$307,780, respectively, of managed services revenues were recognized, that were included in deferred revenue at the beginning of the respective periods. During the three months ended March 31, 2019 and 2018, \$290,045 and \$214,970, respectively, of consulting and professional services revenues were recognized, that were included in deferred revenue at the beginning of the respective periods.

9. LINE OF CREDIT AND TERM LOAN

On January 13, 2017, as part of the acquisition of CTEK Security, Inc. (formerly CynergisTek, Inc.), we entered into an Amended and Restated Credit Agreement (the "A&R Credit Agreement"). The A&R Credit Agreement amended a loan and security agreement originally entered into on May 4, 2012, as amended by several amendments. Under the A&R Credit Agreement, the term of the revolving line-of-credit was available through January 13, 2019, at an interest rate of prime plus 1.0% per annum. The amount available to us at any given time was the lesser of (a) \$5.0 million, or (b) the amount available under our borrowing base (80% of our eligible accounts receivable, minus (1) accrued client lease payables, and minus (2) accrued equipment pool liability). The A&R Credit Agreement provided a term loan facility for \$14,000,000.

There were no borrowings on the line of credit for the three months ended March 31, 2018.

Interest charges associated with this term loan totaled \$133,914 for the three months ended March 31, 2018.

Debt Restructuring

On March 12, 2018, we entered into a Credit Agreement (together with the other related documents defined therein, the "Credit Agreement") with BMO Harris Bank N.A., a national banking association ("Bank"), as lender (the "BMO Loan").

The purposes of the BMO Loan were (1) to refinance and replace the facilities under the A&R Credit Agreement, thus terminating that agreement as of March 12, 2018, (2) to refinance \$2,250,000 of a promissory note held by Michael McMillan (the "McMillan Seller Note"), (3) to finance payments to Michael Hernandez, including the full repayment of a promissory note held by Hernandez (the "Hernandez Seller Note") in the original principal amount of \$4,500,000, also issued as part of the Original SPA, (4) to finance working capital, (5) for general corporate purposes and (6) to fund certain fees and expenses associated with the closing of the BMO Loan.

Loan Facilities

Term Loan: Pursuant to the Credit Agreement, the Bank agreed to provide a term loan in the amount of \$17,250,000 to the Company, which was paid in accordance with the purpose of the BMO Loan as described above.

Pursuant to the Credit Agreement, the Company could elect that the term loan be outstanding as Base Rate Loans or Eurodollar Loans. The term loan was payable in principal payment installments on the last day of each fiscal quarter, commencing on June 30, 2018. All principal and interest not sooner paid on the term loan was due and payable on September 12, 2022, the final maturity thereof.

Revolving Line of Credit: Additionally, pursuant to the Credit Agreement, the Bank agreed to provide a revolving loan or loans to the Company in an aggregate amount of up to \$5,000,000 with a \$500,000 sublimit for the issuance of letters of credit. Pursuant to the Credit Agreement, the Company could elect that each borrowing of revolving loans be either Base Rate Loans or Eurodollar Loans. Each revolving loan, both for principal and interest then outstanding, matured and was due and payable on March 12, 2020, or such earlier date on which the Revolving Credit Commitment (as defined in the Credit Agreement) was terminated in whole pursuant to the Credit Agreement. There were no borrowings on the line of credit for the three months ended March 31, 2019 or 2018.

Beginning June 30, 2018, we were required to maintain certain financial covenants in connection with this credit agreement, including a total leverage ratio, a senior leverage ratio, and a fixed charge coverage ratio. These covenants contain ratios which changed over relevant periods of the credit agreement and could be found in Section 7.13 of the Credit Agreement.

Interest Rates

Base rate loans (“Base Rate Loans”) bear interest at an annual rate equal to the base rate (defined as the highest of (a) the rate of interest quoted in The Wall Street Journal, Money Rates Section as the prime rate in effect on such day, with any change in the Base Rate resulting from a change in such prime rate to be effective as of the date of the relevant change in such prime rate, (b) the sum of (i) the rate determined by the Bank to be the average of the rates per annum quoted to the Bank by two or more Federal funds brokers selected by the Bank for sale to the Bank at face value of Federal funds in the secondary market in an amount equal or comparable to the principal amount for which such rate is being determined, plus (ii) 1/2 of 1%, and (c) the overnight LIBOR rate plus 1.0%) plus an applicable margin of between 1.50% and 2.50%, depending upon the Company’s leverage ratio.

Eurodollar loans (“Eurodollar Loans”) bear interest at a rate per annum equal to the sum of the Adjusted LIBOR rate (defined as the quotient obtained by dividing (a) the LIBOR index rate by (b) the maximum reserve percentage, expressed as a decimal, at which reserves are imposed by the Board of Governors of the Federal Reserve System (or any successor) on “eurocurrency liabilities,” as defined in such Board’s Regulation D (or any successor thereto), subject to any amendments of such reserve requirement by such Board or its successor, taking into account any transitional adjustments thereto) plus an applicable margin of between 2.50% and 3.50%, depending upon the Company’s leverage ratio.

On March 12, 2018, we paid a \$25,000 revolving loan commitment fee associated with the line of credit.

Interest charges associated with the BMO term loan totaled \$207,903 and \$50,217 for the three months ended March 31, 2019 and 2018, respectively. In addition, on March 12, 2018, we paid a \$86,250 commitment fee associated with the term loan.

On March 20, 2019, we used a portion of the proceeds from the sale of the assets of CTEK Solutions business to fully repay the balance of the term loan in the amount of \$15,456,984 plus interest of \$52,760. At that time, the Revolving Credit Commitment was terminated.

10. PROMISSORY NOTES

In connection with the acquisition of CTEK Security, Inc. (formerly CynergisTek, Inc.), we issued two promissory notes totaling \$9,000,000 to Hernandez and McMillan (the “Seller Notes”), with each of the Seller Notes having an initial principal amount of \$4,500,000. These Seller Notes bear interest at 8% per annum, require quarterly interest-only payments during the first 12 months, quarterly payments of principal and interest during the last 24 months, using a 36-month amortization period commencing from that point, with a balloon payment due on the maturity date. Amounts due and owing under the Seller Notes are subordinate to the right of payment due under the A&R

Credit Agreement pursuant to the Subordination Agreement. The Company had the right to prepay all or any portion of the outstanding principal balance of the Seller Notes, provided that such prepayment is accompanied by accrued interest on the amount of principal prepaid, calculated to the date of such prepayment.

On March 12, 2018, the Company fully repaid the \$4,500,000 plus accrued interest on the Hernandez Seller Note.

As part of the debt restructuring with BMO Harris Bank N.A., on March 12, 2018, the Company repaid \$2,250,000 plus accrued interest on the McMillan Seller Note. The Company and Mr. McMillan agreed to amend and restate the McMillan Seller Note pursuant to the A&R McMillan Seller Note. The A&R McMillan Seller Note is in the principal amount of \$2,250,000, bears interest at a rate of 8% per annum, provides for quarterly payments of principal and interest and matures on March 31, 2022. As of March 31, 2019 and December 31, 2018, the outstanding principal balance due under the A&R McMillan Seller Note was \$1,687,500 and \$1,828,125, respectively. Amounts due and owing under the A&R McMillan Seller Note are subordinate to the right of payment due under the BMO Loan pursuant to a Subordination Agreement among the Company, the Bank and Mr. McMillan.

Interest charges associated with the Seller Notes totaled \$35,106 and \$149,425 for the three months ended March 31, 2019 and 2018, respectively.

Pursuant to the Separation Agreement, in lieu of any earn-out payments (as described in the Original SPA (as defined below)) that could be earned by Hernandez under the Original SPA, the Company agreed to pay Hernandez the amount of \$3,750,000 in the form of a promissory note (the “Earn-out Note”). The Earn-out Note provided for (i) a maturity date of March 12, 2023, at which all principal and accrued and unpaid interest was due, (ii) a simple interest rate of 5% per annum commencing on January 1, 2018, and compounding annually, and (iii) the right of the Company to prepay all or any portion of the Earn-out Note without premium or penalty. On March 26, 2019, we used a portion of the proceeds from the sale of the assets of CTEK Solutions business to fully repay the Earn-out Note with interest of \$234,293.

Interest charges associated with the Earn-out Note totaled \$45,858 and \$45,813 for the three months ended March 31, 2019 and 2018, respectively.

Pursuant to the Separation Agreement, the Company also issued a Severance Payment Note to Hernandez in the original principal amount of \$343,750 (the “Severance Payment Note”). The Severance Payment Note bears interest at a rate of 5% per annum, compounded annually, allowed for prepayment by the Company and matured on January 10, 2019, at which time all principal and accrued and unpaid interest was due.

Interest charges associated with the Severance Payment Note totaled \$494 and \$4,191 for the three months ended March 31, 2019 and 2018, respectively.

Amounts due and owing under the Earn-out Note and Severance Payment Note were subordinate to the right of payment due under the BMO Loan pursuant to a Subordination Agreement among the Company, the Bank and Hernandez.

11. REVENUES

Below is a summary of our revenues disaggregated by revenue source.

	<u>Three Months Ended March 31,</u>	
	<u>2019</u>	<u>2018</u>
Managed services	\$ 2,791,740	\$ 2,317,636
Consulting and professional services	2,964,594	2,021,544
Hardware and software resales	<u>17,323</u>	<u>35,389</u>
Net revenues	<u>\$ 5,773,657</u>	<u>\$ 4,374,569</u>

12. OPTIONS, WARRANTS AND RESTRICTED STOCK UNITS

Below is a summary of stock option, warrant and restricted stock activity during the three-month period ended March 31, 2019:

<u>Options</u>	<u>Shares</u>	<u>Weighted Average Exercise Price</u>	<u>Weighted Average Remaining Term in Years</u>	<u>Aggregate Intrinsic Value</u>
Outstanding at December 31, 2018	539,927	\$ 2.97		
Granted	-	-		
Exercised	(21,784)	2.75		
Cancelled	<u>(12,057)</u>	<u>3.34</u>		
Outstanding at March 31, 2019	<u>506,086</u>	<u>\$ 2.99</u>	<u>4.05</u>	<u>\$ 999,901</u>
Exercisable at March 31, 2019	<u>496,306</u>	<u>\$ 3.00</u>	<u>4.05</u>	<u>\$ 977,455</u>

<u>Warrants</u>	<u>Shares</u>	<u>Weighted Average Exercise Price</u>	<u>Weighted Average Remaining Term in Years</u>	<u>Aggregate Intrinsic Value</u>
Outstanding at December 31, 2018	77,779	\$ 3.03		
Granted	-	-		
Exercised	-	-		
Cancelled	<u>-</u>	<u>-</u>		
Outstanding at March 31, 2019	<u>77,779</u>	<u>\$ 3.03</u>	<u>3.80</u>	<u>\$ 150,891</u>
Exercisable at March 31, 2019	<u>77,779</u>	<u>\$ 3.03</u>	<u>3.80</u>	<u>\$ 151,891</u>

<u>Restricted Stock Units</u>	<u>Shares</u>	<u>Weighted Average Price</u>	<u>Weighted Average Remaining Term in Years</u>
Outstanding at December 31, 2018	810,000	\$ 3.67	
Granted	42,600	4.67	
Exercised	(47,455)	3.42	
Cancelled	<u>(24,295)</u>	<u>3.50</u>	
Outstanding at March 31, 2019	<u>780,850</u>	<u>\$ 3.75</u>	<u>1.88</u>

For the three months ended March 31, 2019 and 2018, stock-based compensation expense recognized in the consolidated statements of operations as follows:

	<u>Three Months Ended March 31,</u>	
	<u>2019</u>	<u>2018</u>
Cost of revenues	\$ 175,739	\$ 32,332
Sales and marketing	63,831	57,490
General and administrative expense	<u>167,122</u>	<u>98,440</u>
Total stock-based compensation expense	<u>\$ 406,692</u>	<u>\$188,262</u>

13. NET INCOME (LOSS) PER SHARE

Basic net income (loss) per share is calculated using the weighted average number of shares of our common stock issued and outstanding during a certain period and is calculated by dividing net (loss) income by the weighted average number of shares of our common stock issued and outstanding during such period. Diluted net income (loss) per share is calculated using the weighted average number of common and potentially dilutive common shares outstanding during the period, using the as-if-converted method for secured convertible notes, and the treasury stock method for options and warrants. Diluted net income (loss) per share does not include potentially dilutive securities because such inclusion in the computation would be anti-dilutive.

For the three months ended March 31, 2019, potentially dilutive securities consisted of options and warrants to purchase 583,865 shares of common stock at prices ranging from \$2.28 to \$4.05 per share and 780,850 shares of restricted stock units. Of these potentially dilutive securities, 209,904 of the shares of common stock underlying the options and warrants are included in the computation of diluted earnings per share because the effect of including the remaining instruments would be anti-dilutive. Also included in potentially dilutive securities are 47,455 shares of restricted stock units which vested in March 2019 but had not been issued by period end.

For the three months ended March 31, 2018, potentially dilutive securities consisted of options and warrants to purchase 280,416 shares of common stock at prices ranging from \$0.90 to \$6.45 per share and 500,500 shares of restricted stock units. Of these potentially dilutive securities, none of the shares to purchase common stock from the options and warrants or shares related to the restricted stock units are included in the computation of diluted earnings per share because the effect of including these instruments would be anti-dilutive.

	Three Months Ended March 31,	
	2019	2018
Numerators:		
Net loss from continuing operations	<u>\$(1,489,399)</u>	<u>\$(1,856,412)</u>
Net income from discontinued operations	<u>\$19,036,830</u>	<u>\$ 1,149,069</u>
Net income (loss)	<u>\$17,547,431</u>	<u>\$ (707,343)</u>
Denominator:		
Denominator for basic calculation weighted average shares	9,673,689	9,586,608
Dilutive common stock equivalents:		
Options and warrants	209,904	-
Restricted stock units vested but not issued	<u>47,455</u>	<u>-</u>
Denominator for diluted calculation weighted average shares	<u>9,931,048</u>	<u>9,586,608</u>
Net income (loss) per share:		
From continuing operations		
Basic	<u>\$ (0.15)</u>	<u>\$ (0.19)</u>
Diluted	<u>\$ (0.15)</u>	<u>\$ (0.19)</u>
From discontinued operations		
Basic	<u>\$ 1.97</u>	<u>\$ 0.12</u>
Diluted	<u>\$ 1.92</u>	<u>\$ 0.12</u>
Net income (loss)		
Basic	<u>\$ 1.81</u>	<u>\$ (0.07)</u>
Diluted	<u>\$ 1.77</u>	<u>\$ (0.07)</u>

14. REMAINING PERFORMANCE OBLIGATIONS

Remaining performance obligations represent the amount of revenue from fixed-fee contracts, including those which have potential early cancellation provisions, for which work has not been performed. As of March 31, 2019, approximately \$25,000,000 of revenue from fixed-fee contracts is expected to be recognized from these remaining performance obligations. We expect to recognize revenue on approximately 87% of these remaining performance obligations over the next 24 months, with the balance thereafter. We elected to utilize the practical expedient exemption to exclude from this disclosure, the amount of revenue from contracts which are not fixed-fee and where we do not have the right to invoice until the services have been performed.

15. EMPLOYMENT AGREEMENTS

Michael H. McMillan

In January 2017, we entered into an employment agreement with Michael H. McMillan (“McMillan”) (the “McMillan Employment Agreement”), pursuant to which we employed McMillan as President and Chief Strategy Officer of the Company. The initial term of the McMillan Employment Agreement is 36 months and will automatically renew for subsequent 12-month terms unless either party provides written notice to the other party of a desire to not renew the agreement.

Pursuant to the McMillan Employment Agreement, the Company has the right to terminate McMillan’s employment without cause at any time on thirty (30) days’ advance written notice to McMillan. Additionally, McMillan has the right to resign for “Good Reason” (as defined in the McMillan Employment Agreement) on thirty (30) days’ written notice. In the event of (i) such termination without cause, or (ii) McMillan’s inability to perform the essential functions of his position due to a mental or physical disability or his death, or (iii) McMillan’s resignation for Good Reason, McMillan is entitled to receive the base salary then in effect and full target annual bonus, prorated to the date of termination, and a “Severance Payment” equivalent to (a) payment of compensation for an additional twelve months, payable as a lump sum, and (b) the acceleration of all unvested stock options and warrants then held by McMillan, subject to certain conditions set forth in the McMillan Employment Agreement. If McMillan resigns for other than Good Reason, he will be entitled to receive the base salary for the thirty (30) day written notice period, but no other amounts. On October 2, 2017, the Board appointed McMillan as Chief Executive Officer and his base salary was increased to \$325,000.

In February 2018, the Company amended the McMillan Employment Agreement to extend the term thereof through December 31, 2020 and increased his base salary to \$334,700 for 2018, \$359,700 for 2019, and the 2020 base salary to be determined by the Board of Directors at the end of the 2019 calendar year. He will also be eligible for a bonus of up to \$219,375 and \$242,798 in 2018 and 2019, respectively, and his 2020 bonus will be up to 67.5% of his base salary. The foregoing is a summary of the McMillan Employment Agreement, the full context of which is found as Exhibit 99.6 to our Current Report on Form 8-K filed with the SEC on January 17, 2017, and the amendment to the McMillan Employment Agreement, which is found as Exhibit 10.44 to our Annual Report on Form 10-K filed with the SEC on March 28, 2018.

Paul T. Anthony

Effective January 1, 2016, we entered into an employment agreement with Paul T. Anthony (the “Anthony Agreement”). The Anthony Agreement provides that Mr. Anthony will continue to serve as our Executive Vice President, CFO and Corporate Secretary. The Anthony Agreement has a term of two years and provided for an annual base salary of \$245,000. The Anthony Agreement will automatically renew for subsequent twelve (12) month terms unless either party provides advance written notice to the other that such party does not wish to renew the agreement for a subsequent twelve (12) months. Mr. Anthony also receives the customary employee benefits available to our employees. Mr. Anthony was also entitled to receive a bonus of up to \$132,000 per year, the achievement of which is based on Company performance metrics. We may terminate Mr. Anthony’s employment under the Anthony Agreement without cause at any time on thirty (30) days advance written notice, at which time Mr. Anthony would receive severance pay for twelve months and be fully vested in all options and warrants granted to date. The foregoing is a summary of the Anthony Agreement, the full context of which is found as Exhibit 10.32 to our Annual Report on Form 10-K filed with the SEC on March 30, 2016. In March 2017, the Board of Directors

authorized an increase in Mr. Anthony's base salary to \$250,000 and increased his potential annual bonus amount to \$150,000.

In February 2018, the Company amended the Anthony Agreement to extend the term thereof through December 31, 2020 and increased his base salary to \$284,700 for 2018, and \$309,700 for 2019, with the 2020 base salary to be determined by the Board of Directors at the end of the 2019 calendar year. He will also be eligible for a bonus of up to \$185,625 and \$209,047 in 2018 and 2019, respectively, and his 2020 bonus will be up to 67.5% of his base salary. The foregoing is a summary of the Anthony Agreement, the full context of which is found as Exhibit 10.32 to our Annual Report on Form 10-K filed with the SEC on March 30, 2016, and the amendment to the Anthony Agreement, which is found as Exhibit 10.45 to our Annual Report on Form 10-K filed with the SEC on March 28, 2018.

16. CONCENTRATIONS

Cash Concentrations

At times, cash balances held in financial institutions are in excess of federally insured limits. Management performs periodic evaluations of the relative credit standing of financial institutions and limits the amount of risk by selecting financial institutions with a strong credit standing.

Major Customers

Our largest customer accounted for approximately 25% and 14% of our revenues for the three months ended March 31, 2019 and 2018, respectively. Our largest customer had accounts receivable totaling approximately \$1,200,000 and \$400,000 as of March 31, 2019 and December 31, 2018, respectively.

17. DISCONTINUED OPERATIONS

On March 20, 2019, we, along with our wholly-owned subsidiary, CTEK Solutions, Inc., entered into an Asset Purchase Agreement (together with the other related documents defined therein, the "Purchase Agreement") with Vereco, LLC, a Delaware limited liability company ("Buyer"). Pursuant to the Purchase Agreement, we sold our assets used in the provision of our managed print services business division (the "MPS Business"), which had been primarily conducted by CTEK Solutions, Inc. The Buyer also assumed certain liabilities relating to the MPS Business. The purchase price paid to us by Buyer pursuant to the Purchase Agreement was \$30,000,000, \$5,000,000 of which was placed in escrow by Buyer, the release of which is contingent upon certain events and conditions specified in the Purchase Agreement. The purchase price is subject to adjustment based on closing working capital results of the MPS Business. The initial working capital adjustment reduced the cash received by \$629,746.

The following is the summary of the transaction selling the MPS Business:

Cash received	\$ 24,370,254
Escrow balance receivable	5,000,000
Reserve for contingent items	(1,500,000)
Expected final working capital adjustment	(1,214,937)
Book value of net assets disposed	<u>(2,816,198)</u>
Gain before provision for income taxes	23,839,119
Income tax expense	<u>5,675,517</u>
Net gain from sale of discontinued operations	<u>\$ 18,163,602</u>

The following are the carrying amounts of assets and liabilities included as part of discontinued operations:

	March 31, 2019	December 31, 2018
Accounts receivable, net	\$ -	\$ 5,124,270
Prepaid and other current assets	-	2,118,665
Supplies	-	1,184,474
Currents assets held for sale	\$ -	\$ 8,427,409
Property and equipment, net	\$ -	\$ 327,332
Goodwill	-	1,517,017
Noncurrent assets held for sale	\$ -	\$ 1,844,349
Accounts payable and accrued expenses	\$ 40,754	\$ 5,098,179
Accrued compensation and benefits	98,140	1,225,057
Deferred revenue	-	888,467
Current portion of long-term liabilities	-	87,857
Current liabilities held for sale	\$ 138,894	\$ 7,299,561
Operating lease liability	\$ -	\$ 58,567
Noncurrent liabilities held for sale	\$ -	\$ 58,967

The following is a composition of the line items constituting net income from discontinued operations:

	Three Months Ended March 31,	
	2019	2018
Net revenues	\$ 12,096,885	\$ 12,008,748
Cost of revenues	(10,060,414)	(9,876,060)
Sales and marketing	(126,314)	(131,176)
General and administrative expenses	(691,398)	(459,637)
Depreciation	(36,635)	(56,519)
Interest expense	(1,956)	(3,728)
Income before provision for income taxes	1,180,168	1,481,628
Income tax expense	(306,940)	(363,026)
Net income from discontinued operations	\$ 873,228	\$ 1,118,602

The following is a composition of the capital expenditures, and any significant noncash operating and investing items, including depreciation, of the discontinued operations.

	Three Months Ended March 31,	
	2019	2018
Depreciation	\$ 36,635	\$ 56,519
Stock compensation	\$ 124,348	\$ 9,815
Capital expenditures	\$ -	\$ 12,163

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS.

The following discussion of the financial condition and results of operations of the Company should be read in conjunction with the condensed consolidated financial statements and the related notes thereto included elsewhere in this Quarterly Report on Form 10-Q. This Quarterly Report on Form 10-Q contains forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995, Section 21E of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), and Section 27A of the Securities Act, and is subject to the safe harbors created by those sections. Words such as "anticipates," "expects," "intends," "plans," "believes," "seeks," "estimates," "may," "will" and variations of these words or similar expressions are intended to identify forward-looking statements. In addition, any statements that refer to expectations, projections or other characterizations of future events or circumstances, including any underlying assumptions, are forward-looking statements. These statements are not guarantees of future performance and are subject to risks, uncertainties and assumptions that are difficult to predict. Therefore, our actual results could differ materially and adversely from those expressed in any forward-looking statements as a result of various factors. We undertake no obligation to revise or publicly release the results of any revisions to these forward-looking statements.

Due to possible uncertainties and risks, readers are cautioned not to place undue reliance on the forward-looking statements contained in this Quarterly Report, which speak only as of the date of this Quarterly Report, or to make predictions about future performance based solely on historical financial performance. We disclaim any obligation to update forward-looking statements contained in this Quarterly Report.

Readers should carefully review the risk factors described in other documents we file from time to time with the SEC, including our Form 10-K for the fiscal year ended December 31, 2018. Our filings with the SEC, including our Annual Reports on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K and amendments to those filings, pursuant to Sections 13(a) and 15(d) of the Exchange Act, are available free of charge at www.CynergisTek.com, when such reports are available via the EDGAR system maintained by the SEC at www.sec.gov.

OVERVIEW

We are a top-ranked cybersecurity, privacy and compliance firm offering a suite of comprehensive services and solutions with an emphasis in healthcare and the challenges unique to the healthcare industry. Our service offerings help organizations identify ever-changing threat factors and security risks, provide resources to remediate or fill a gap in skilled and experienced talent, and offer a partner with experts in cybersecurity and privacy to manage and advise on their programs.

Our services include our Compliance Assist Partner Program (CAPP), which provides on-going risk assessments and remediation tracking to ensure organizations are compliant with HIPAA. Our Virtual Chief Information Security Officer (CISO) helps organizations with program development and prioritizes projects. The use of the CISO often reveals gaps in an organization's security. We can then provide additional resources through our Staffing service to execute a remediation plan or work on other IT security projects. Our Vendor Security Management oversees third-party risk and our Incident Response services help address the growing ransomware and malware attacks that plague organizations today.

To address growing market needs, we recently expanded our consulting and managed services offerings to include Medical Device Security Risk Assessment and Managed Security Services. The Medical Device Security Risk Assessment service helps hospitals and other organizations inventory the increasing number of medical devices connected to the network, identify hard to find vulnerabilities to overall security and the patient, and categorize these risks into a clearly defined remediation plan. The Managed Security Services provide on-going monitoring and analysis of an organization's security posture in regard to its network, endpoint devices, cloud infrastructure and SaaS applications.

As of March 20, 2019, the Company is focused exclusively on cybersecurity and privacy. As reported in our prior public filings, beginning March 20, 2019, we no longer provide Managed Print Services (MPS) directly but will continue to refer our customers to our partners for these services. MPS optimizes high-volume print environments

while reducing costs, improving efficiency and securing the print environment through industry best practices. Our common stock currently trades on the NYSE American under the stock symbol “CTEK”.

Where appropriate, references to “CynergisTek,” the “Company,” “we,” “us” or “our” include CynergisTek, Inc., a Delaware corporation and its wholly-owned subsidiaries, CTEK Solutions, Inc., a California corporation, CTEK Security, Inc., a Texas corporation, and Delphiis, Inc., a California corporation.

APPLICATION OF CRITICAL ACCOUNTING POLICIES

Our discussion and analysis of our financial condition and results of operations are based upon our financial statements, which have been prepared in accordance with GAAP. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and the related disclosure of contingent assets and liabilities. We evaluate these estimates on an on-going basis, including those estimates related to customer programs and incentives, product returns, bad debts, supplies, investments, intangible assets, income taxes, contingencies and litigation. We base our estimates on historical experience and on various other assumptions that we believe to be reasonable under the circumstances. The results of these estimates form the basis for our judgments about the carrying values of assets and liabilities which are not readily apparent from other sources. As a result, actual results may differ from these estimates under different assumptions or conditions.

We consider the following accounting policies to be most important to the portrayal of our financial condition and those that require the most subjective judgment:

- **Revenue recognition and deferred revenue**

We operate under a consolidated strategy and management structure, deriving revenue from the following sources:

- Managed services
- Consulting and professional services
- Hardware and software resales

Revenue is recognized pursuant to ASC Topic 606, “Revenue from Contracts with Customers” (ASC 606). Accordingly, revenue is recognized at an amount that reflects the consideration to which we expect to be entitled in exchange for transferring goods or services to a customer. This principle is applied using the following 5-step process:

1. Identify the contract with the customer
2. Identify the performance obligations in the contract
3. Determine the transaction price
4. Allocate the transaction price to the performance obligations in the contract
5. Recognize revenue when (or as) each performance obligation is satisfied

Managed Services

Managed services revenue is earned monthly during the term of the contract, as services and supplies are provided at a fixed fee and is recognized ratably over the contract term beginning on the commencement date of the contract. Managed services contracts are typically long-term contracts lasting 3 to 5 years.

Consulting and Professional Services

Consulting and professional services contracts are typically short-term, project-based services rendered on either a fixed fee or a time and materials basis. These contracts are normally for a duration of less than one year. For fixed fee arrangements, revenue is recognized ratably over the term of the project. For time and materials arrangements, revenues are recognized as the services are rendered.

Hardware and Software Resales

For hardware and software resales, we recognize revenue on a gross basis, as we are deemed to be the primary obligor in these arrangements. Revenue from the resale of hardware is recognized when delivered to the customer. For software resales, when we do not provide any services that are considered essential to the functionality of the software, revenue is recognized upon delivery of the software. All product warranties and upgrades or enhancements are provided exclusively by the manufacturer. We do not sell any internally-developed software.

For hardware and software maintenance arrangements, we recognize revenue at the time of sale on a net basis, as a third-party service provider is deemed to be the primary obligor. Under net sales recognition, the cost of the third-party service provider or vendor is recorded as a direct reduction to net revenues on the statements of operations.

Deferred and Unbilled Revenue

We receive payments from customers based on billing schedules established in our contracts. Deferred revenue primarily consists of billings or payments received in advance of the amount of revenue recognized and such amounts are recognized as the revenue recognition criteria are met. Unbilled revenue reflects our conditional right to receive payment from customers for our completed performance under contracts.

- **Accounts receivable valuation and related reserves**

We estimate the losses that may result from that portion of our accounts receivable that may not be collectible as a result of the inability of our customers to make required payments. Management specifically analyzes customer concentration, customer credit worthiness, current economic trends and changes in customer payment terms when evaluating the adequacy of the allowance for doubtful accounts. We review past due accounts on a monthly basis and record an allowance for doubtful accounts where we deem appropriate.

- **Impairment review of goodwill and intangible assets**

We periodically evaluate our intangible assets and goodwill relating to acquisitions for impairment. Goodwill is not amortized but is evaluated at least annually at year end for any impairment in the carrying value. We review our intangible assets for impairment whenever events or changes in circumstances indicate that the carrying value of such assets may not be recoverable. Factors we consider important which could trigger an impairment review include, but are not limited to, the following: significant underperformance relative to expected historical or projected future operating results; significant changes in the manner of our use of the acquired assets or the strategy for our overall business; and a significant negative industry or economic trend for a sustained period. Goodwill and intangible asset impairment assessments are generally determined based on fair value techniques, including determining the estimated future discounted and undiscounted cash flows over the remaining useful life of the asset. Those models require estimates of future revenue, profits, capital expenditures and working capital for each reporting unit. We estimate these amounts by evaluating historical trends, the current state of the Company's industries and the economy, current budgets, and operating plans. Determining the fair value of reporting units and goodwill includes significant judgment by management and different judgments could yield different results. Any resulting impairment loss could have a material impact on our financial condition and results of operations.

- **Stock-based compensation**

Under the fair value recognition provisions of the authoritative guidance, stock-based compensation cost granted to employees is measured at the grant date based on the fair value of the award and is recognized as expense over the requisite service or performance period, which is the vesting period. Stock options and warrants issued to consultants and other non-employees as compensation for services to be provided to us are accounted for based upon the fair value of the services provided or the estimated fair value of the option or warrant, whichever can be more clearly determined. We currently use the Black-Scholes option pricing model to determine the fair value of stock options. The determination of the fair value of stock-based payment awards on the date of grant using an option-pricing model is affected by our stock price as well as assumptions regarding a number of complex and subjective variables. These variables include our expected stock price volatility over the term of the awards, the expected term of the award, the risk-free interest rate and any expected dividends. Compensation cost associated with grants of restricted stock units are also measured at fair

value. We evaluate the assumptions used to value restricted stock units on a quarterly basis. When factors change, including the market price of the stock, share-based compensation expense may differ significantly from what has been recorded in the past. If there are any modifications or cancellations of the underlying unvested securities, we may be required to accelerate, increase or cancel any remaining unearned share-based compensation expense.

- **Income taxes**

Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial reporting requirements and those imposed under federal and state tax laws. Deferred taxes are provided for timing differences in the recognition of revenue and expenses for income tax and financial reporting purposes and are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date. Deferred income tax expense represents the change during the period in the deferred tax assets and liabilities. Realization of the deferred tax asset is dependent on generating sufficient taxable income in future years. Deferred tax assets are reduced by a valuation allowance when, in the opinion of management, it is more likely than not that some portion or all of the deferred tax assets will not be realized.

Reference is made to our Annual Report on Form 10-K for the fiscal year ended December 31, 2018 filed with the SEC on March 27, 2019, for additional discussion of our critical accounting policies.

RESULTS OF OPERATIONS

For the Three Months Ended March 31, 2019, Compared to the Three Months Ended March 31, 2018

Revenue

Revenue increased by approximately \$1,400,000 to \$5,773,657 for the three months ended March 31, 2019, as compared to the same period in 2018 as we have intensified our sales efforts, expanded our service offerings and benefitted from our customers need for additional professional services. This increase is a result of an approximately \$500,000 increase in multi-year managed service revenues and approximately \$900,000 in additional revenues from consulting and professional services provided to new and existing customers, largely from professional staffing services contracts.

Cost of Revenue

Cost of revenue consists primarily of salaries and related expenses of direct labor and indirect support staff. Cost of revenue was \$3,484,639 for the three months ended March 31, 2019, as compared to \$2,408,780 for the same period in 2018. We incurred approximately \$800,000 more in salaries and related costs, approximately \$100,000 more in stock compensation, and approximately \$200,000 in contract labor. These increases were due to increased headcount in order to provide services to a larger customer base, to support new services and our efforts to augment the employee salary and benefit offerings to attract and retain talent.

Gross margin was 40% of revenue for the three months ended March 31, 2019, and 45% for the same period in 2018. The reduction in gross margin is reflective of our investment in attracting and retaining talented cyber security employees and costs associated with ramping up new services. Over the next few quarters, we expect gross margins to improve as we look to grow our cyber security consulting services.

Sales and Marketing

Sales and marketing expenses include salaries, commissions and expenses for sales and marketing personnel, travel and entertainment, and other selling and marketing costs. Sales and marketing expenses were \$1,481,383 for the three months ended March 31, 2019, as compared to \$1,367,871 for the same period in 2018. The increase is

primarily a result of increases in sales commissions earned as a result of an increase in bookings for the compared periods.

General and Administrative

General and administrative expenses include personnel costs for finance, administration, information systems, and general management, as well as facilities expenses, professional fees, legal expenses and other administrative costs. General and administrative expenses decreased by \$515,658 to \$1,653,633 for the three months ended March 31, 2019, as compared to \$2,169,291 for the three months ended March 31, 2018. The decrease is due to approximately \$600,000 in severance paid to a departed executive in 2018. This is partially offset by an increase in stock compensation expense of approximately \$100,000 as a result of an increase in the issuance of restricted stock units to key employees and board members.

Depreciation

Depreciation remained steady at \$38,985 for the three months ended March 31, 2019, as compared to \$35,064 for the same period in 2018.

Amortization of Acquisition-Related Intangibles

Amortization of acquisition-related intangibles remained the same at \$452,734 for each of the three months ended March 31, 2019 and 2018. The composition of identified intangible assets was consistent over the compared periods and there was no impairment affecting these assets.

Other Income (Expense)

Interest expense for the three months ended March 31, 2019 was \$295,905, compared to \$399,733 for the same period in 2018. The decrease was due to a lower average principal balance on the bank term loan and certain sellers promissory notes for the compared periods, due to scheduled quarterly principal payments. We expect interest expense to decrease substantially in future periods based since we repaid the bank term loan and certain sellers promissory notes in March 2019.

Income Tax Expense

Income tax benefit for the three months ended March 31, 2019 was \$144,214, compared to income tax benefit of \$602,472 for the same period in 2018. These amounts were based on estimated annual income tax rates we anticipate for the year. The 2019 rate is also influenced by the tax rate on the gain on the sale of the MPS company.

Income from Discontinued Operations, Including Gain on Sale, Net of Tax

On March 20, 2019, we sold the net assets of our MPS business. The gain on the sale of this business together with the earnings from these discontinued operations totaled \$19,304,463. This compares to the earnings from these discontinued operations in the first quarter of 2018 totaling \$1,149,069.

LIQUIDITY AND CAPITAL RESOURCES

At March 31, 2019, our cash and cash equivalents were \$12,386,637 and our working capital was \$11,621,383. Our principal cash requirements are for operating expenses, including employee costs and capital expenditures as well as debt service to our related party sellers note and income taxes. Our primary sources of cash are revenues from operations and the sale of the MPS business.

During the three months ended March 31, 2019, our cash provided by operating activities amounted to \$1,148,830, as compared to \$647,953 provided by operating activities for the same period in 2018. We have been able to maintain a positive position in providing cash from operations by staying current on collections and selling profitable service contracts.

As discussed above, in March 2019, we sold the MPS business and received initial cash of approximately \$24,400,000 upon which we repaid approximately \$15,400,000 remaining on a bank term loan. We also repaid approximately \$4,200,000 in notes payable to related parties. As a result of the repayment of the term loan to the bank, we terminated the availability of a \$5,000,000 line of credit with them. We may seek additional financing or equity raises; however, there can be no assurance that additional financing will be available on acceptable terms, if at all. Any financing or equity raises may result in dilution to existing stockholders and any debt financing may include restrictive covenants. Management believes that cash generated from operations, together with existing cash reserves will be sufficient to sustain our business operations over at least the next twelve months.

OFF-BALANCE SHEET ARRANGEMENTS

As of March 31, 2019, we did not have any other relationships with unconsolidated entities or financial partners, such as entities often referred to as structured finance or special purpose entities, which would have been established for the purpose of facilitating off-balance sheet arrangements or other contractually narrow or limited purposes.

CONTRACTUAL OBLIGATIONS AND CONTINGENT LIABILITIES AND COMMITMENTS

As of March 31, 2019, expected future cash payments related to contractual obligations and commercial commitments were as follows:

	Payments Due by Period				
	Total	Less than 1 year	1-3 years	3-5 years	More than 5 years
Promissory notes	\$ 1,907,476	\$ 681,010	\$1,226,466	\$ -	\$ -
Capital leases	1,013	1,013	-	-	-
Operating leases	1,113,960	619,466	494,494	-	-
Total	<u>\$ 3,022,449</u>	<u>\$ 1,301,489</u>	<u>\$1,720,960</u>	<u>\$ -</u>	<u>\$ -</u>

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK.

As a “smaller reporting company” as defined by Rule 229.10(f)(1), we are not required to provide the information required by this Item 3.

ITEM 4. CONTROLS AND PROCEDURES.

We maintain disclosure controls and procedures (as defined in Rules 13a-15(c) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the “Exchange Act”)) that are designed to ensure that information required to be disclosed in our reports under the Exchange Act, is recorded, processed, summarized and reported within the time periods specified in the SEC’s rules and forms, and that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure.

We carried out an evaluation, under the supervision and with the participation of our management, including our Chief Executive Officer (principal executive officer) and Chief Financial Officer (principal financial officer), of the effectiveness of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act), as of the end of the period covered by this Quarterly Report. Based upon that evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were effective as of the end of the period covered by this Quarterly Report to ensure that information required to be disclosed by us in the reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the Securities Exchange Commission’s rules and forms, and that such information is accumulated and communicated to our management, including each of such officers as appropriate to allow timely decisions regarding required disclosure.

No change in our internal control over financial reporting that occurred during our last fiscal quarter that has materially affected or is reasonably likely to materially affect our internal control over financial reporting.

PART II - OTHER INFORMATION

ITEM 1A. RISK FACTORS.

As of the date of this filing, there have been no material changes to the Risk Factors included in our Annual Report on Form 10-K for the fiscal year ended December 31, 2018, filed with the SEC on March 27, 2019 (the “2018 Form 10-K”). The Risk Factors set forth in the 2018 Form 10-K should be read carefully in connection with evaluating our business and in connection with the forward-looking statements contained in this Quarterly Report on Form 10-Q. Any of the risks described in the 2018 Form 10-K could materially adversely affect our business, financial condition or future results and the actual outcome of matters as to which forward-looking statements are made. These are not the only risks we face. Additional risks and uncertainties not currently known to us or that we currently deem to be immaterial also may materially adversely affect our business, financial condition and/or operating results.

ITEM 6. EXHIBITS.

No.	Item
10.1	Asset Purchase Agreement (filed as Exhibit 10.1 to the Current Report on Form 8-K filed with the SEC on March 26, 2019, and incorporated herein by reference)
10.2	Sublease Agreement (filed as Exhibit 10.2 to the Current Report on Form 8-K filed with the SEC on March 26, 2019, and incorporated herein by reference)
31.1	Certification of the Chief Executive Officer pursuant to Rule 13a-14(a) and Rule 15d-14(a) of the Securities Exchange Act of 1934, as amended. †
31.2	Certification of the Chief Financial Officer pursuant to Rule 13a-14(a) and Rule 15d-14(a) of the Securities Exchange Act of 1934, as amended. †
32.1	Certification of the CEO and CFO pursuant to Rule 13a-14(b) and Rule 15d-14(b) of the Securities Exchange Act of 1934 and 18 U.S.C. Section 1350. +
101.INS	XBRL Instance Document*
101.SCH	XBRL Taxonomy Extension Schema Document*
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document*
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document*
101.LAB	XBRL Taxonomy Extension Label Linkbase Document*
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document*

† Filed herewith.

+ Furnished herewith. In accordance with Item 601(b)(32)(ii) of Regulation S-K, this exhibit shall not be deemed “filed” for the purposes of Section 18 of the Securities and Exchange Act of 1934 or otherwise subject to the liability of that section, nor shall it be deemed incorporated by reference in any filing under the Securities Act of 1933 or the Securities Exchange Act of 1934.

* Pursuant to Rule 406T of Regulation S-T, this XBRL information will not be deemed “filed” for the purpose of Section 18 of the Securities Exchange Act of 1934 or otherwise subject to the liability of that section, nor will it be deemed filed or made a part of a registration statement or prospectus for purposes of Sections 11 and 12 of the Securities Act of 1933, or otherwise subject to liability under those sections.

EXHIBIT 31.1

CERTIFICATION OF THE CHIEF EXECUTIVE OFFICER PURSUANT TO RULE 13A-14(A) AND RULE 15D-14(A) OF THE SECURITIES EXCHANGE ACT OF 1934, AS AMENDED

I, Michael McMillan, certify that:

1. I have reviewed this Quarterly Report on Form 10-Q of CynergisTek, Inc. (the “Registrant”);
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant’s other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
 - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - (c) Evaluated the effectiveness of the registrant’s disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - (d) Disclosed in this report any change in the registrant’s internal control over financial reporting that occurred during the registrant’s most recent fiscal quarter (the registrant’s fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant’s internal control over financial reporting; and
5. The registrant’s other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant’s auditors and the audit committee of the registrant’s board of directors (or persons performing the equivalent functions):
 - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant’s ability to record, process, summarize and report financial information; and
 - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant’s internal control over financial reporting.

Dated: May 14, 2019

/s/ Michael McMillan
Michael McMillan,
Chief Executive Officer
(Principal Executive Officer)

EXHIBIT 31.2

CERTIFICATION OF THE CHIEF FINANCIAL OFFICER PURSUANT TO RULE 13A-14(A) AND RULE 15D-14(A) OF THE SECURITIES EXCHANGE ACT OF 1934, AS AMENDED

I, Paul T. Anthony, certify that:

1. I have reviewed this Quarterly Report on Form 10-Q of CynergisTek, Inc. (the “Registrant”);
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant’s other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
 - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - (c) Evaluated the effectiveness of the registrant’s disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - (d) Disclosed in this report any change in the registrant’s internal control over financial reporting that occurred during the registrant’s most recent fiscal quarter (the registrant’s fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant’s internal control over financial reporting; and
5. The registrant’s other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant’s auditors and the audit committee of the registrant’s board of directors (or persons performing the equivalent functions):
 - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant’s ability to record, process, summarize and report financial information; and
 - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant’s internal control over financial reporting.

Dated: May 14, 2019

/s/ Paul T. Anthony
Paul Anthony ,
Chief Financial Officer
(Principal Financial Officer)

EXHIBIT 32.1

CERTIFICATION OF THE CHIEF EXECUTIVE OFFICER AND CHIEF FINANCIAL OFFICER PURSUANT TO RULE 13A-14(B) AND RULE 15D-14(B) OF THE SECURITIES EXCHANGE ACT OF 1934 AND 18 U.S.C. SECTION 1350

In connection with the Quarterly Report of CynergisTek, Inc. (the “Company”) on Form 10-Q for the quarter ended March 31, 2019, as filed with the Securities and Exchange Commission on the date hereof (the “Report”), we, Michael McMillan, Chief Executive Officer and Paul T. Anthony, Chief Financial Officer of the Company, certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that to the best of our knowledge:

- (1) The Report fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended; and
- (2) The information contained in the Report fairly presents, in all material respects, the financial condition of the Company as of the dates presented and the results of operations of the Company for the periods presented.

Date: May 14, 2019

By: /s/ Michael McMillan
Michael McMillan,
Chief Executive Officer

By: /s/ Paul T. Anthony
Paul Anthony,
Chief Financial Officer

A signed original of this written statement required by section 906 has been provided to the Company and will be retained by the Company and furnished to the Securities and Exchange Commission or its staff upon request.

This certification accompanies the Quarterly Report pursuant to Rule 13a-14(b) or Rule 15d-14(b) under the Securities Exchange Act of 1934 and 18 U.S.C. Section 1350 and shall not be deemed filed by the Company for purposes of Section 18 of the Securities Exchange Act of 1934.