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

FORM 10-Q

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

For the quarterly period ended September 30, 2018

[ ] 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	**37-1867101**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

27271 Las Ramblas, Suite 200
Mission Viejo, California 92691
(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 ☑.

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 November 8, 2018 was 9,616,133.

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PART I – FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS.

CYNERGISTEK, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEETS

	September 30, 2018 (unaudited)	December 31, 2017
ASSETS		
Current assets:		
Cash and cash equivalents	$ 6,355,427	$ 4,252,060
Accounts receivable, net	9,389,407	13,264,323
Prepaid and other current assets	1,583,463	557,426
Supplies	1,043,964	1,156,006
Total current assets	18,372,261	19,229,815
Property and equipment, net	648,895	831,784
Deposits	87,778	87,376
Deferred income taxes	2,930,051	3,120,310
Intangible assets, net	9,542,722	10,900,924
Goodwill	18,525,206	18,525,206
Total assets	$ 50,106,913	$ 52,695,415
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable and accrued expenses	$ 3,639,637	$ 9,631,634
Accrued compensation and benefits	3,792,516	3,711,551
Deferred revenue	1,144,555	1,425,821
Note payable	343,750	-
Current portion of long-term liabilities	3,120,504	5,494,837
Total current liabilities	12,040,962	20,263,843
Long-term liabilities:		
Term loan, less current portion	14,075,843	9,438,333
Promissory notes to related parties, less current portion	5,156,250	6,000,000
Capital lease obligations, less current portion	77,500	147,861
Total long-term liabilities	19,309,593	15,586,194
Commitments and contingencies		
Stockholders' equity:		
Common stock, par value at $0.001, 33,333,333 shares authorized, 9,616,133 shares issued and outstanding at September 30, 2018 and 9,576,028 shares issued and outstanding at December 31, 2017	9,616	9,576
Additional paid-in capital	31,619,720	31,156,362
Accumulated deficit	(12,872,978)	(14,320,560)
Total stockholders' equity	18,756,358	16,845,378
Total liabilities and stockholders' equity	$ 50,106,913	$ 52,695,415

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 September 30,		Nine Months Ended September 30,	
	2018	2017	2018	2017
Net revenues	$ 19,216,066	$ 17,897,076	$ 52,536,317	$ 52,950,678
Cost of revenues	13,428,831	11,743,838	38,131,617	37,847,138
Gross profit	5,787,235	6,153,238	14,404,700	15,103,540
Operating expenses:				
Sales and marketing	1,313,388	1,329,909	4,288,893	4,070,765
General and administrative	1,789,959	1,849,164	6,405,355	5,876,895
Depreciation	84,840	97,568	265,424	287,727
Amortization of acquisition-related intangibles	452,734	520,030	1,358,201	1,560,716
Total operating expenses	3,640,921	3,796,671	12,317,873	11,796,103
Income from operations	2,146,314	2,356,567	2,086,827	3,307,437
Other income (expense):				
Other income	17	1,862	44	1,884
Interest expense	(348,480)	(373,408)	(1,103,592)	(1,162,289)
Total other income (expense)	(348,463)	(371,546)	(1,103,548)	(1,160,405)
Income before provision for income taxes	1,797,851	1,985,021	983,279	2,147,032
Income tax expense	(643,725)	(895,360)	(415,363)	(976,899)
Net income	$ 1,154,126	$ 1,089,661	$ 567,916	$ 1,170,133
Net income per share:				
Basic	$ 0.12	$ 0.11	$ 0.06	$ 0.12
Diluted	$ 0.12	$ 0.11	$ 0.06	$ 0.12
Number of weighted average shares outstanding:				
Basic	9,616,133	9,501,760	9,605,536	9,387,264
Diluted	9,762,370	9,881,236	9,813,098	9,835,428

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

CYNERGISTEK, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY
NINE MONTHS ENDED SEPTEMBER 30, 2018
(UNAUDITED)

	Common Stock		Additional Paid-in Capital	Accumulated Deficit	Total Stockholders' Equity
	Shares	Amount			
Balance at December 31, 2017	9,576,028	$ 9,576	$ 31,156,362	$ (14,320,560)	$ 16,845,378
Cumulative effect of adoption of revenue recognition standard ASC 606 (Note 7)	-	-	-	879,666	879,666
Stock compensation expense for options and warrants granted to employees and directors	-	-	28,996	-	28,966
Stock compensation expense for restricted stock units granted to employees and directors	-	-	434,402	-	434,402
Stock options exercised	40,105	40	(40)	-	-
Net income	-	-	-	567,916	567,916
Balance at September 30, 2018	9,616,133	$ 9,616	$ 31,619,720	$ (12,872,978)	$ 18,756,358

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

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

	Nine Months Ended September 30,	
	2018	**2017**
Cash flows from operating activities:		
Net income	$ 567,916	$ 1,170,133
Adjustments to reconcile net income to net cash provided by (used for) operating activities:		
Depreciation	265,424	287,727
Amortization of intangible assets	1,358,201	1,560,716
Deferred income taxes	190,259	726,258
Bad debts	109,673	109,207
Stock compensation expense for warrants and options granted to employees and directors	28,996	74,973
Stock compensation expense for restricted stock units granted to employees and directors	434,402	98,347
Note payable issued for severance pay	343,750	-
Interest expense related to loan acquisition costs	17,450	-
Changes in operating assets and liabilities:		
Accounts receivable	3,765,243	(1,495,401)
Supplies	112,042	112,869
Prepaid and other current assets	(146,370)	(558,943)
Deposits	(402)	(45,854)
Accounts payable and accrued expenses	(2,241,997)	(2,933,971)
Accrued compensation and benefits	80,965	(36,368)
Deferred revenue	(281,266)	196,927
Net cash provided by (used for) operating activities	4,604,286	(733,380)
Cash flows from investing activities:		
Purchases of property and equipment	(82,535)	(258,981)
Amount paid to purchase CynergisTek, net of cash received	-	(13,448,522)
Net cash used for investing activities	(82,535)	(13,707,503)
Cash flows from financing activities:		
Proceeds from term loan	17,250,000	14,000,000
Loan acquisition fees paid	(111,250)	-
Payments on term loans	(12,434,404)	(2,836,667)
Payments on promissory notes to related parties	(7,031,250)	-
Payments on capital leases	(91,480)	(130,526)
Proceeds from issuance of common stock through stock options and warrants	-	66,452
Net cash (used for) provided by financing activities	(2,418,384)	11,099,259
Net increase (decrease) in cash and cash equivalents	2,103,367	(3,341,624)
Cash and cash equivalents, beginning of period	4,252,060	6,090,844
Cash and cash equivalents, end of period	$ 6,355,427	$ 2,749,220

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)

	Nine Months Ended September 30,	
	2018	**2017**
Supplemental disclosure of cash flow information:		
Interest paid	$ 1,214,439	$ 920,393
Income taxes paid	$ 226,170	$ 256,252
Non-cash investing and financing activities:		
Property and equipment acquired through capital leases	$ -	$ 128,939
Common stock issued in connection with the acquisition of CynergisTek, Inc.	$ -	$ 2,771,999
Promissory notes issued in connection with the acquisition of CynergisTek, Inc.	$ -	$ 9,000,000
Fair value of earn-out liability in connection with the acquisition of CynergisTek, Inc.	$ -	$ 2,356,000

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

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
NINE MONTHS ENDED SEPTEMBER 30, 2018 AND 2017
(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, 2017, as filed with the Securities and Exchange Commission ("SEC") on March 28, 2018.

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 the Company's recent integration with CTEK Security and an analysis of how our Chief Operating Decision Maker reviews, manages and is compensated, we have determined that the Company operates in two segments, services and equipment & software resale. The equipment & software resale operating segment is not reported separately in the accompanying condensed consolidated financial statements, as this segment did not meet the quantitative thresholds established in ASC 280-10-50-12. 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.

2. RECENTLY ISSUED ACCOUNTING PRONOUNCEMENTS

In May 2014, the FASB issued guidance which provides a single, comprehensive accounting model for revenue arising from contracts with customers ("Topic 606"). This guidance supersedes most of the existing revenue recognition guidance, including industry-specific guidance. Under this model, revenue is recognized at an amount that a company expects to be entitled to upon transferring control of goods or services to a customer, as opposed to when risks and rewards transfer to a customer. The new guidance also requires additional disclosures about the nature, timing and uncertainty of revenue and cash flow arising from customer contracts, including significant judgments and changes in judgments. We adopted this standard beginning January 1, 2018 and are using the modified retrospective method of adoption. Under the new guidance, based on the nature of our contracts, we will continue to recognize revenue in a similar manner as with the current guidance. Additionally, the unit of accounting, that is, the identification of performance obligations, is consistent with current revenue guidance. Accordingly, the adoption of this standard did not significantly impact our revenues. The additional disclosures required by Topic 606 are presented in Notes 3, 7, 9 and 10.

In February 2016, the FASB issued a new accounting standard on leasing. The new standard will require companies to record most leased assets and liabilities on the balance sheet, and also proposes a dual model for recognizing

expense. This guidance will be effective in the first quarter of 2019 with early adoption permitted. We have evaluated the impact of adopting this guidance and we are preparing for the changes to be made to our consolidated financial statements. We expect the adoption of these accounting changes will materially increase our assets and liabilities but will not have a material impact on our net income or equity.

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, goodwill impairment will be recognized as the difference between the fair value and the carrying value. The new standard becomes effective on January 1, 2020 with early adoption permitted. We are currently evaluating the impact that the new standard will have on our financial position, results of operations and cash flows.

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 is 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. We are currently evaluating the impact of adopting this standard 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 will be effective for the Company for the year ending December 31, 2019 and interim reporting periods within that year. Early adoption is permitted for transactions that have not been reported in financial statements that have been issued or made available for issuance. We are currently evaluating the effect of the adoption of this guidance on our consolidated financial statements.

In May 2017, the FASB issued 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 will be effective for the year ending December 31, 2019 and interim reporting periods within that year. Early adoption is permitted. We expect the adoption of this guidance will not have a material effect on our consolidated financial statements or footnotes.

3. REVENUES

On January 1, 2018, we adopted Topic 606 using a modified retrospective method applied to those customer contracts which were not completed as of January 1, 2018. There was no change in revenues reported using this method as compared to the previous guidance. Below is a summary of our revenues disaggregated by revenue source.

	Three Months Ended September 30,		**Nine Months Ended September 30,**	
	2018	**2017**	**2018**	**2017**
Managed services	$ 13,594,227	$ 15,175,852	$ 40,155,977	$ 45,530,347
Consulting & professional services	2,911,982	1,931,169	6,708,121	4,837,297
Office equipment, hardware & software resales	2,709,857	790,055	5,672,219	2,583,034
Net revenues	$ 19,216,066	$ 17,897,076	$ 52,536,317	$ 52,950,678

4. OPTIONS, WARRANTS AND RESTRICTED STOCK UNITS

Below is a summary of stock option, warrant and restricted stock activity during the nine-month period ended September 30, 2018:

Options	Shares	Weighted Average Exercise Price	Weighted Average Remaining Term in Years	Aggregate Intrinsic Value
Outstanding at December 31, 2017	724,400	$ 3.09		
Granted	-	-		
Exercised	(40,105)	2.74		
Cancelled	(105,756)	3.88		
Outstanding at September 30, 2018	578,539	$ 2.97	3.82	$ 520,796
Exercisable at September 30, 2018	543,423	$ 2.97	3.82	$ 488,666

Warrants	Shares	Weighted Average Exercise Price	Weighted Average Remaining Term in Years	Aggregate Intrinsic Value
Outstanding at December 31, 2017	77,779	$ 3.03		
Granted	-	-		
Exercised	-	-		
Cancelled	-	-		
Outstanding at September 30, 2018	77,779	$ 3.03	4.55	$ 63,779
Exercisable at September 30, 2018	77,779	$ 3.03	4.55	$ 63,779

Restricted Stock Units	Shares	Weighted Average Price	Weighted Average Remaining Term in Years
Outstanding at December 31, 2017	506,500	$ 3.35	
Granted	-	-	
Exercised	-	-	
Cancelled	(65,500)	3.68	
Outstanding at September 30, 2018	441,000	$ 3.30	1.75

For the three and nine months ended September 30, 2018 and 2017, stock-based compensation expense recognized in the consolidated statements of operations as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2018	2017	2018	2017
Cost of revenues	$ 21,148	$ 5,585	$ 82,173	$ 32,509
Sales and marketing	42,625	51,000	87,875	95,602
General and administrative	97,492	13,287	293,350	45,209
Total stock-based compensation expense	$ 161,264	$ 69,872	$ 463,398	$ 173,320

5. NET INCOME PER SHARE

Basic net income 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 income by the weighted average number of shares of our common stock issued and outstanding during such period. Diluted net income 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 per share does not include potentially dilutive securities because such inclusion in the computation would be anti-dilutive.

For the three months ended September 30, 2018, potentially dilutive securities consisted of options and warrants to purchase 656,318 shares of common stock at prices ranging from $0.90 to $6.45 per share and 441,000 shares of restricted stock units. Of these potentially dilutive securities, only 146,237 of the shares to purchase common stock from the options and warrants and none of the 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.

For the nine months ended September 30, 2018, potentially dilutive securities consisted of options and warrants to purchase 656,318 shares of common stock at prices ranging from $0.90 to $6.45 per share and 441,000 shares of restricted stock units. Of these potentially dilutive securities, only 207,562 of the shares to purchase common stock from the options and warrants and none of the 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.

For the three months ended September 30, 2017, potentially dilutive securities consisted of options and warrants to purchase 1,416,747 shares of common stock at prices ranging from $0.90 to $6.45 per share. Of these potentially dilutive securities, 379,476 of the shares to purchase common stock from 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.

For the nine months ended September 30, 2017, potentially dilutive securities consisted of options and warrants to purchase 1,416,747 shares of common stock at prices ranging from $0.90 to $6.45 per share. Of these potentially dilutive securities, 448,164 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.

	Three Months Ended September 30,		**Nine Months Ended September 30,**	
	2018	**2017**	**2018**	**2017**
Numerator:				
Net income	$ 1,154,126	$ 1,089,661	$ 567,916	$ 1,170,133
Denominator:				
Denominator for basic calculation weighted average shares	9,616,133	9,501,760	9,605,536	9,387,264
Dilutive common stock equivalents:				
Options and warrants	146,237	379,476	207,562	448,164
Denominator for diluted calculation weighted average shares	9,762,370	9,881,236	9,813,098	9,835,428
Net income per share:				
Basic net income per share	$ .12	$ .11	$ .06	$ .12
Diluted net income per share	$ .12	$ .11	$ .06	$ .12

6. ACCOUNTS RECEIVABLE

A summary of accounts receivable is as follows:

	September 30, 2018	December 31, 2017
Trade receivables	$ 11,051,436	$ 14,451,899
Unbilled revenue, net and unapplied advances	(1,662,029)	(1,081,525)
Allowance for doubtful accounts	-	(106,551)
Total accounts receivable, net	$ 9,389,407	$ 13,264,323

7. DEFERRED COMMISSIONS

Our incremental costs of obtaining a contract, which consist of sales commissions on multi-year contracts, are deferred and amortized over the period of contract performance. Effective January 1, 2018, when we adopted the modified retrospective method of the new revenue recognition pronouncement, we increased deferred commissions by $879,666 with a corresponding increase in beginning retained earnings. Deferred commissions are included in prepaid and other current assets in our consolidated balance sheets. As of September 30, 2018, we had $1,016,751 related to unamortized deferred commissions. We had $211,920 and $633,060 of commissions expense for the three and nine months ended September 30, 2018, respectively. Commissions expense for the three and nine months ended September 30, 2017 were $232,968 and $611,059, respectively. If we had recognized commissions expense under the full retrospective approach, commission expense would have been $171,611 and $507,799, respectively, for the three and nine months ended September 30, 2017.

8. INTANGIBLE ASSETS

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

	September 30, 2018			December 31, 2017		
	Gross Carrying Amount	Accumulated Amortization	Accumulated Impairment	Gross Carrying Amount	Accumulated Amortization	Accumulated Impairment
Delphiis, Inc.						
Acquired technology	$ 900,000	$ (254,754)	$ (547,484)	$ 900,000	$ (242,002)	$ (547,484)
Customer relationships	400,000	(233,257)	(166,743)	400,000	(233,257)	(166,743)
Trademarks	50,000	(50,000)	-	50,000	(50,000)	-
Non-compete agreements	20,000	(17,292)	(2,708)	20,000	(17,292)	(2,708)
Total Delphiis, Inc.	$ 1,370,000	$ (555,303)	$ (716,935)	$ 1,370,000	$ (542,551)	$ (716,935)
Redspin						
Acquired technology	$ 1,050,000	$ (297,095)	$ (331,908)	$ 1,050,000	$ (248,519)	$ (331,908)
Customer relationships	600,000	(550,000)	(50,000)	600,000	(550,000)	(50,000)
Trademarks	200,000	(93,978)	(106,022)	200,000	(93,978)	(106,022)
Non-compete agreements	100,000	(46,951)	(53,049)	100,000	(46,951)	(53,049)
Total Redspin	$ 1,950,000	$ (988,024)	$ (540,979)	$ 1,950,000	$ (939,448)	$ (540,979)
CTEK Security, Inc.						
Acquired technology	$ 8,150,000	$ (1,426,250)	$ -	$ 8,150,000	$ (815,000)	$ -
Customer relationships	2,150,000	(940,625)	-	2,150,000	(537,500)	-
Trademarks	1,550,000	(542,500)	-	1,550,000	(310,000)	-
Non-compete agreements	200,000	(116,662)	-	200,000	(66,663)	-
Total CTEK Security, Inc.	$ 12,050,000	$ (3,026,037)	$ -	$ 12,050,000	$ (1,729,163)	$ -
Total intangible assets	$ 15,370,000	$ (4,569,364)	$(1,257,914)	$ 15,370,000	$ (3,211,162)	$ (1,257,914)

9. DEFERRED REVENUE

We record deferred revenues when amounts are billed to customers, or cash is received from customers, in advance of our performance. $578,725 and $932,994 of managed services revenues were recognized during the nine months ended September 30, 2018 and 2017, respectively, that was included in deferred revenue at the beginning of the respective periods. $523,505 and $250,766 of consulting and professional services revenues were recognized during the nine months ended September 30, 2018 and 2017, respectively, that was included in deferred revenue at the beginning of the respective periods.

10. 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 September 30, 2018, approximately $23,000,000 of revenue from fixed-fee contracts is expected to be recognized from these remaining performance obligations. We expect to recognize revenue on approximately 88% 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.

11. 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") with California Bank and Trust and Avidbank Corporate Finance, a Division of Avidbank (collectively the "Lenders"). The A&R Credit Agreement amended a loan and security agreement originally entered into on May 4, 2012, as amended by several amendments, between the Company and AvidBank Corporate Finance. 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). As of December 31, 2017, no amounts were outstanding under the line of credit. The A&R Credit Agreement provided a term loan facility for $14,000,000. As of December 31, 2017, outstanding borrowings under the term loan were $11,818,333 at an interest rate of 6.0%. We were in compliance with all covenants set forth in the A&R Credit Agreement as of December 31, 2017.

The foregoing descriptions of the A&R Credit Agreement is qualified in its entirety by reference to the actual terms and conditions of such agreement, which is found in our Form 8-K filed on January 17, 2017 as Exhibit 99.7 thereto.

Interest charges associated with borrowings on the line of credit for the three and nine months ended September 30, 2017 were $1,285 and $1,285, respectively. In addition, on January 13, 2017, we paid a $25,000 revolving loan commitment fee.

Interest charges associated with the term loans totaled $184,964 and $343,028, respectively, for the three and nine months ended September 30, 2017. In addition, on January 13, 2017, we paid a $70,000 term loan commitment fee.

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 are (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 Dr. Michael Hernandez (f/k/a Dr. Michael G.

Mathews), including the full repayment of a promissory note held by Hernandez (the “Hernandez Seller Note”; together with the McMillan Seller Note, the “Seller Notes”) in the original principal amount of $4,500,000, also issued as part of the Original SPA (as defined below), (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 may elect that the term loan be outstanding as Base Rate Loans or Eurodollar Loans. The term loan is 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 shall be due and payable on September 12, 2022, the final maturity thereof. As of September 30, 2018, outstanding borrowings under the term loan were $16,017,857 at an interest rate of 5.64%.

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 may 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, shall mature and be due and payable on March 12, 2020, or such earlier date on which the Revolving Credit Commitment (as defined in the Credit Agreement) is terminated in whole pursuant to the Credit Agreement.

Beginning June 30, 2018, we are required to maintain certain financial covenants in connection with the Credit Agreement, including a total leverage ratio, a senior leverage ratio, and a fixed charge coverage ratio. These covenants contain ratios which change over relevant periods of the Credit Agreement and can be found in Section 7.13 of the Credit Agreement. As of September 30, 2018, we were in compliance with all of the Credit Agreement’s financial covenants.

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.

There were no borrowings on the BMO line of credit for the nine months ended September 30, 2018. During the nine months ended September 30, 2018, we paid $37,638 in revolving loan commitment fees associated with the line of credit.

Interest charges associated with the BMO term loan totaled $234,989 and $521,785 for the three and nine months ended September 30, 2018. In addition, in March 2018, we paid a $86,250 commitment fee associated with the term loan.

Acceleration

Pursuant to the Credit Agreement, the Bank may, by written notice to the Company, declare the principal of and the accrued interest on all outstanding loans to be forthwith due and payable upon the occurrence of certain Events of Default. The Credit Agreement defines Events of Default to include, inter alia, (i) a default in payment when due of all or any part of any obligation payable by the Company under the BMO Loan, (ii) a default in the observance or performance of certain of the covenants set forth in the BMO Loan, (iii) any representation or warranty made in connection with the BMO Loan proves untrue in any respect (or in any material respect if such representation, warranty, certification or statement is not by its terms already qualified as to materiality), (iv) default on any subordinated debt, (v) any judgment or judgments, writ or writs or warrant or warrants of attachment shall be entered or filed against the Company or any of its subsidiaries, or against any of its Property, in an aggregate amount in excess of $250,000 (except to the extent fully covered by insurance as to which the insurer has been notified of such judgment and has not denied coverage) which remains undischarged, unvacated, unbonded or unstayed for a period of 30 days, (vi) any change of control of the Company shall occur, and (vii) any other specified event of default.

Security Agreement

In connection with the Credit Agreement, the Company, including its subsidiaries as guarantors ("Guarantors"), and the Bank entered into a Pledge and Security Agreement (the "Security Agreement"), pursuant to which each of the Company and the Guarantors agreed to grant to the Bank a lien on and security interest in certain collateral to secure prompt payment and performance of the secured obligations under the Credit Agreement. Pursuant to the Security Agreement, the "Collateral" was defined as including, inter alia, any and all (all such terms as defined in the Security Agreement) of the Accounts, Chattel Paper, Instruments (including Promissory Notes), Documents, General Intangibles, Letter-of-Credit Rights, Supporting Obligations, Deposit Accounts, Pledged Collateral and other Investment Property (including all certificated and uncertificated Securities, Securities Accounts, Security Entitlements, Commodity Accounts, and Commodity Contracts), Goods, Fixtures, Inventory and Equipment, Commercial Tort Claims, and Rights to merchandise and other Goods, any Monies, personal property, and interests in personal property, in each case whether now existing or hereafter acquired or created, any money or other assets of any grantor that now or hereafter come into the possession, custody, or control of Bank and any Proceeds or products of any of the foregoing, or any portion thereof. In connection with the grant of the security interest in the Collateral, each of the Company and the Guarantors made standard representations and warranties relating to ownership of the collateral, location and control of the collateral, and certain rights to payment.

The foregoing summary of the Credit Agreement and related agreements is qualified in its entirety by reference to the full context of the agreements, which are found in our Current Report on Form 8-K filed with the SEC on March 12, 2018.

Separation Agreement and Mutual Release with Hernandez

On March 12, 2018, the Company, CTEK Security and Hernandez entered into a Separation Agreement and Mutual Release (the "Separation Agreement").

Pursuant to the Separation Agreement, Hernandez's employment with the Company as the Company's Chief Operating Officer was terminated and the Company and Hernandez mutually agreed to release the other from any and all claims, disputes, demands, actions, liabilities, damages, suits (whether at law or in equity), promises, accounts, costs, expenses, setoffs, contributions, attorneys' fees and/or causes of action of whatever kind or character, whether past, present, future, known or unknown, liquidated or unliquidated, accrued or unaccrued, from the beginning of time, or which may hereinafter accrue as a result of the discovery of new and/or additional facts, which such party has had, may now have, or might claim to have, arising out of the agreements between the parties or any transaction contemplated thereby, based upon the acts or omissions of the other party prior to the date of the Separation Agreement.

Further, 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

provides for (i) a maturity date of March 12, 2023, at which all principal and accrued and unpaid interest is 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. As a result, the Company recorded an additional accrual of $1,394,000 at December 31, 2017 related to the earn-out contingent liability.

Also pursuant to the Separation Agreement, the Company paid off the outstanding amount due under the Hernandez Seller Note and paid Hernandez a severance payment consisting of a $250,000 payment upon execution of the Separation Agreement and the delivery of a promissory note 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, compounds annually, allows for prepayment by the Company and matures on January 10, 2019, at which time all principal and accrued and unpaid interest is due.

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

Amendment to CTEK Security, Inc. (formerly CynergisTek, Inc.) Stock Purchase Agreement; Amended and Restated Promissory Note

On March 12, 2018, the Company, CTEK Security and McMillan entered into an Amendment to Stock Purchase Agreement (“Amendment”). Pursuant to the Amendment, certain provisions of the Stock Purchase Agreement dated as of January 13, 2017 which memorialized the acquisition of CTEK Security, Inc. (formerly CynergisTek, Inc.) (the “Original SPA”) related to the Earn-Out (as defined in the Original SPA and described in the Company’s Form 8-K dated January 13, 2017) were amended. The earn-out provisions were amended to remove all obligations to make earn-out payments to Hernandez. As to McMillan, the Amendment modified the maximum earn-out payment which could be earned by McMillan to $1,200,000, with a maximum of $400,000 per year based on revised performance metrics (rather than the benchmarks described in the Original SPA) during the 2018, 2019 and 2020 calendar years, as determined by the Company’s board of directors and/or a committee thereof.

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 an Amended and Restated Promissory Note (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. 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. Mr. McMillan is a director and the President and Chief Executive Officer of the Company.

12. PROMISSORY NOTES

In connection with the acquisition of CTEK Security, Inc. (formerly CynergisTek, Inc.) we issued two promissory notes totaling $9,000,000 to Michael Hernandez and Michael 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.

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. (Note 10), 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. Accordingly, principal payments totaling $281,250 plus

interest of $81,986 were made in 2018. 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.

The foregoing descriptions of the Seller Notes are qualified in their entirety by reference to such notes. The Seller Notes are found in our Form 8-K filed on January 17, 2017 as Exhibits 99.3 and 99.4. The foregoing descriptions of the A&R McMillan Seller Note are qualified in their entirety by reference such note, which is found in our Form 8-K filed on March 13, 2018 as Exhibit 10.5.

Interest charges associated with the Seller Notes totaled $41,610 and $234,986, respectively for the three and nine months ended September 30, 2018, and $179,507 and $331,397, respectively for the three months and nine months ended September 30, 2017.

Pursuant to the Separation Agreement (see Note 11), in lieu of any earn-out payments (as described in the Original SPA) 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 provides for (i) a maturity date of March 12, 2023, at which all principal and accrued and unpaid interest is 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.

Interest charges associated with the Earn-out Note totaled $47,713 and $140,721, respectively, for the three and nine months ended September 30, 2018.

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, compounds annually, allows for prepayment by the Company and matures on January 10, 2019, at which time all principal and accrued and unpaid interest is due.

Interest charges associated with the Severance Payment Note totaled $4,332 and $12,808, respectively for the three and nine months ended September 30, 2018.

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

13. 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 summary of the McMillan Employment Agreement is qualified in its entirety by reference to the full context of the agreement, 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 and CFO. 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 summary of the Anthony Agreement is qualified in its entirety by reference to the full context of the employment agreement, 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 summary of the Anthony Agreement is qualified in its entirety by reference to the full context of the agreement, 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.

14. 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 two largest customers accounted for approximately 57% of our revenues for the nine months ended September 30, 2018 and our two largest customers accounted for approximately 44% of our revenues for the nine months ended September 30, 2017. Our largest customers had accounts receivable totaling approximately $4,100,000 and $5,600,000 as of September 30, 2018 and December 31, 2017, respectively.

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, 2017. 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 engaged in the business of providing IT and related consulting services, including managed print services, cyber security, and IT security consulting services primarily to the healthcare industry. Our business is operated throughout the United States.

We have been an industry leader in managed print services for the healthcare industry for many years, offering hospitals and health systems comprehensive services and solutions to support the document life cycle. We provide a vendor neutral program that enhances security of printed, stored data and digital documents while driving out costs and inefficiencies within the patient information logistical chain. We also provide IT security consulting services through our proprietary Delphiis™ IT Risk Manager SaaS Solution and Redspin.

In January 2017, we acquired CTEK Security, Inc. (formerly CynergisTek, Inc.) ("CTEK Security"), a top-ranked cybersecurity and privacy consulting firm, transforming and significantly expanding our cybersecurity and IT security consulting services capabilities. Our security experts perform technical assessments, penetration testing and remediation services, in addition to providing 24/7 advisory services to our Compliance Assist Partner Program ("CAPP") customers. With our proven and prescriptive methodology, we help build the foundation needed to ensure the confidentiality, integrity and security of patient health information (PHI). Our proprietary RiskSonar IT Risk Manager SaaS Solution streamlines how covered entities perform annual and on-going risk assessments on their business associates, clinics, projects and hospitals.

Following the acquisition of CTEK Security, we have integrated our managed print services, IT security and cybersecurity operations and are going to market as an integrated cybersecurity and managed print services company. We believe that offering our current and prospective hospital customers with a comprehensive integrated

offering to address privacy, security and compliance of their IT environment and related electronic and physical records provides a significant competitive advantage to the Company. In addition, the Company resells equipment and software to support our client's infrastructure needs in areas of their business that are related to the services we provide.

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. and its wholly-owned subsidiaries, CTEK Solutions, Inc., CTEK Security, Inc., and Delphiis, Inc..

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
  - Office equipment, 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

<u>Managed Services</u>

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.

Our contracts with customers may include provisions that relate to guaranteed savings amounts and shared savings. Such provisions are considered by management during our initial proprietary client assessment. Our historical settlement of such amounts has been within management's estimates.

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.

Office Equipment, Hardware and Software Resales

Revenues from office equipment sales transactions are recognized upon delivery of the identified performance obligation. For equipment that is to be installed at a customer's location at a future date, revenue is deferred until the installation of such equipment.

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.

Arrangements with Multiple Deliverables

We enter into contracts that include multiple deliverables, which typically consist of the sale of Multi-Function Device ("MFD") equipment and a managed services contract. We evaluate the deliverables in each contract to determine if they represent distinct performance obligations as defined in ASC 606. Revenue is allocated to each performance obligation based on its relative standalone selling price. When standalone selling prices are not readily observable, it can be estimated using an adjusted market assessment approach, an expected cost-plus margin approach, or a residual approach. We generally do not sell MFD equipment on a standalone basis, but as we purchase the equipment, we have evidence of the cost of this element. We estimate the transaction price of the contract to allocate to the managed service unit based on historical cost experience. Based on the relative costs of each performance obligation to the overall transaction price of the contract, we utilize the same relative percentage to allocate the total transaction price.

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.

- **New customer implementation costs**

We ordinarily incur additional costs to implement our services for new customers. These costs are comprised primarily of additional labor and support. These costs are expensed as incurred and have a negative impact on our statements of operations and cash flows during the implementation phase. We also estimate certain document imaging equipment lease and service costs, as well as expected volumes from managed document services. These estimates may impact gross margin during the implementation phase.

- **Goodwill and intangible assets with indefinite lives**

The Company accounts for its business combinations in accordance with the Financial Accounting Standards Board ("FASB") Accounting Standard Codification ("ASC") 805-10 through ASC 805-50, "Business Combinations" which requires that the purchase method of accounting be applied to all business combinations and addresses the criteria for initial recognition of intangible assets and goodwill. In accordance with FASB ASC 350-10 through ASC 350-30, goodwill and other intangible assets with indefinite lives are not amortized but are tested for impairment annually, or more frequently if circumstances indicate the possibility of impairment. If the carrying value of goodwill or an indefinite lived intangible asset exceeds its fair value, an impairment loss shall be recognized.

To test for goodwill impairment, first we perform a qualitative assessment. If we determine, based on qualitative factors, that the fair value of goodwill is more likely than not greater than the carrying amount, a quantitative calculation would not be needed. Our methodology for a quantitative assessment of testing for goodwill impairment consists of one, and possibly two steps. In step one of the goodwill impairment test, management compares the carrying amount (including goodwill) of the reporting unit and the fair value. If the carrying value of the reporting unit exceeds the fair value of the reporting unit, then an impairment charge is recognized for the amount by which the goodwill carrying value exceeds the implied fair value of goodwill.

- **Long-lived assets**

In accordance with ASC Topic 350, long-lived assets, such as definite lived intangible assets, to be held and used are analyzed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. If there are indications of impairment, we use future undiscounted cash flows of the related asset or asset grouping over the remaining life in measuring whether the assets are recoverable. In the event such cash flows are not expected to be sufficient to recover the recorded asset values, the assets are written down to their estimated fair value. Long-lived assets to be disposed of are reported at the lower of carrying amount or fair value of asset less the cost to sell.

- **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, 2017 filed with the SEC on March 28, 2018 for additional discussion of our critical accounting policies.

RESULTS OF OPERATIONS

For the Three Months Ended September 30, 2018 Compared to the Three Months Ended September 30, 2017

Revenue

Revenue increased by approximately $1,300,000 to $19,216,066 for the three months ended September 30, 2018, as compared to the same period in 2017. This increase is a result of 1) approximately $1,600,000 less in managed service revenues consisting of approximately $800,000 in additional revenues from the net expansion of existing customers and contracts from new customers offset by approximately $2,400,000 in non-renewals of long-term contracts,; 2) approximately $1,000,000 in additional revenues from the consulting and professional services provided to new and existing customers, and 3) approximately $2,700,000 in equipment revenues in 2018 compared to approximately $800,000 for the same period in 2017. The increase in consulting and professional services was a direct result of our additional efforts in selling these types of services to take advantage of the industry-wide labor shortfall.

Cost of Revenue

Cost of revenue consists of salaries and expenses of direct labor and indirect support staff as well as document imaging equipment, parts and supplies. Cost of revenue was $13,428,831 for the three months ended September 30, 2018, as compared to $11,743,838 for the same period in 2017. We incurred approximately $200,000 less in staffing costs, including contract labor, largely as a result of the net reduction in managed services contracts. Equipment costs increased by approximately $1,900,000 in 2018, directly as a result of the increase in equipment revenues from copier fleet refresh activities.

Gross margin dollars for the three months ended September 30, 2018 are lower by $366,003 in comparison to the same period in 2017, due to the reduction in managed services revenues, partially offset by the increase in professional services and consulting revenues. Gross margin was 30% of revenue for the three months ended September 30, 2018 compared to 34% for the same period in 2017. While our managed, consulting and professional services maintained consistent gross margin percentages, the overall decrease is due primarily to the increase in lower margin equipment revenues in the third quarter of 2018.

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 $1,313,388 for the three months ended September 30, 2018, as compared to $1,329,909 for the same period in 2017. Our sales and marketing efforts were relatively consistent 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 $59,205 to $1,789,959 for the three months ended September 30, 2018, as compared to $1,849,164 for the three months ended September 30, 2017. The decrease in general and administrative expenses is attributed to 1) approximately $100,000 more in administrative salaries and related costs reflective of an increase in executive compensation as a result of restructuring earn-out provisions, 2) approximately $100,000 less in professional fees where 2017 included the costs to reincorporate in Delaware and change the Company name, 3) approximately $100,000 less in bad debt expense in 2018, 4) approximately $100,000 less in rent and related office expenses due to consolidating Texas offices in 2018 and 5) approximately $100,000 increase in stock compensation expense as a result of an increase in the issuance of restricted stock units to key employees and board members.

Depreciation

Depreciation remained steady at $84,840 for the three months ended September 30, 2018 as compared to $97,568 for the same period in 2017.

Amortization of Acquisition-Related Intangibles

Amortization of acquisition-related intangibles decreased by $67,296 to $452,734 for the three months ended September 30, 2018 as compared to $520,030 for the same period in 2017. The decrease is primarily a result of impairment charges taken in late 2017 on identified intangible assets associated with the acquisitions of Delphiis, Inc. and Redspin which would otherwise be amortized in future periods.

Other Income (Expense)

Interest expense for the three months ended September 30, 2018 was $348,480 compared to $373,408 for the same period in 2017. The slight decrease was due to a lower interest rate on the bank term loan for the compared periods.

Income Tax Expense

Income tax expense for the three months ended September 30, 2018 was $643,725 compared to $895,360 for the same period in 2017. Income tax expense is based on estimated annual income tax rates that we anticipate for the tax years. The lower 2018 effective tax rate is reflective of lower U.S. corporate income tax rates compared with 2017.

For the Nine Months Ended September 30, 2018 Compared to the Nine Months Ended September 30, 2017

Revenue

Revenue decreased by approximately $400,000 to $52,536,317 for the nine months ended September 30, 2018, as compared to the same period in 2017. This decrease is a result of 1) approximately $5,400,000 less in managed service revenues consisting of approximately $3,400,000 in additional revenues from the net expansion of existing customers and contracts from new customers, offset by approximately $8,800,000 in non-renewals of long-term contracts; 2) approximately $1,900,000 in additional revenues from consulting and professional services provided to new and existing customers, and 3) approximately $5,700,000 in equipment revenues in 2018 compared to approximately $2,600,000 for the same period in 2017. The increase in consulting and professional services was a direct result of our additional efforts in selling these types of services to take advantage of the industry-wide labor shortfall.

Cost of Revenue

Cost of revenue consists of salaries and expenses of direct labor and indirect support staff as well as document imaging equipment, parts and supplies. Cost of revenue was $38,131,617 for the nine months ended September 30, 2018, as compared to $37,847,138 for the same period in 2017. We incurred approximately $1,000,000 less in staffing costs, including contract labor, approximately $1,200,000 less in supplies and third-party services, and approximately $300,00 less in travel costs, largely as a result of the net reduction in managed services contracts. Equipment costs increased by approximately $3,000,000 in 2018, directly as a result of the increase in equipment revenues from copier fleet refresh activities.

Gross margin dollars for the nine months ended September 30, 2018 are lower by $698,840 in comparison to the same period in 2017, due to the reduction in managed services revenues, partially offset by the increase in professional services and consulting revenues. Gross margin was 27% of revenue for the nine months ended September 30, 2018 as compared to 29% for the same period in 2017. While our managed, consulting and professional services maintained consistent gross margin percentages, the overall decrease is due primarily to the increase in lower margin equipment revenues in 2018.

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 $4,288,893 for the nine months ended September 30, 2018, as compared to $4,070,765 for the same period in 2017. Sales staff compensation increased by approximately $100,000 and tradeshow and forum related marketing expenses were approximately $100,000 more in 2018 as we actively pursue new business.

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 increased by $528,460 to $6,405,355 for the nine months ended September 30, 2018, as compared to $5,876,895 for the nine months ended September 30, 2017. The increase in general and administrative expenses is attributed to 1) approximately $600,000 in severance paid to a departed executive, accounting and other administrative staff related to CTEK Security; 2) approximately $300,000 increase in administrative salaries and related costs reflective of an increase in executive compensation as a result of restructuring earn-out provisions as well as hiring additional recruiting and IT positions; 3) approximately $200,000 increase in stock compensation expense as a result of an increase in the issuance of restricted stock units to key employees and board members; 4) approximately $300,000 decrease in professional fees in 2018, where in 2017 professional fees were incurred in connection with the acquisition of CTEK Security as well as to reincorporate in Delaware and change the Company name, and 5) approximately $300,000 less in office and travel costs in 2018 where there was an increase in 2017 as a result of the integration of the newly acquired CTEK Security Texas office.

Depreciation

Depreciation remained steady at $265,424 for the nine months ended September 30, 2018 as compared to $287,727 for the same period in 2017.

Amortization of Acquisition-Related Intangibles

Amortization of acquisition-related intangibles decreased by $202,515 to $1,358,201 for the nine months ended September 30, 2018 as compared to $1,560,716 for the same period in 2017. The decrease is a primarily a result of impairment charges taken in late 2017 on identified intangible assets associated with the acquisitions of Delphiis, Inc. and Redspin which would otherwise be amortized in future periods.

Other Income (Expense)

Interest expense for the nine months ended September 30, 2018 was $1,103,592 compared to $1,162,289 for the same period in 2017. The slight decrease was due to a lower interest rate on the bank term loan for the compared periods.

Income Tax Expense

Income tax expense for the nine months ended September 30, 2018 was $415,363 compared to $976,899 for the same period in 2017. Income tax expense is based on estimated annual income tax rates that we anticipate for the tax years. The lower 2018 effective tax rate is reflective of lower U.S. corporate income tax rates compared with 2017.

LIQUIDITY AND CAPITAL RESOURCES

At September 30, 2018, our cash and cash equivalents were $6,355,427 and our working capital was $6,331,299. Our principal cash requirements are for operating expenses, including equipment, supplies, employee costs and capital expenditures as well as debt service to our bank term loan and related party sellers' notes. Our primary sources of cash are revenues from operations and our bank line of credit.

During the nine months ended September 30, 2018, our cash provided by operating activities amounted to $4,604,286, as compared to $733,380 used for operating activities for the same period in 2017. The increase in cash provided for operating activities in 2018 is primarily due to a significant improvement in accounts receivable collections from the previous year.

In March 2018, we restructured our debt and paid $6,750,000 of $9,000,000 in sellers' notes related to the acquisition of CTEK Security, Inc. and repaid approximately $11,200,000 remaining on a bank term loan. To fund this, we borrowed $17,250,000 under a new five-year term loan agreement with a bank where we also have in place the availability of a $5,000,000 line of credit, subject to borrowing base limits. We may seek additional debt 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 future cash flows 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

Our off-balance sheet arrangements consist primarily of conventional operating leases arising in the normal course of business, as further discussed below under "Contractual Obligations and Contingent Liabilities and Commitments." As of September 30, 2018, 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 September 30, 2018, 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**
Term loan and promissory notes	$ 26,048,916	$ 4,380,006	$ 7,485,563	$ 14,183,347	$ -
Capital leases	178,940	100,382	78,558	-	-
Operating leases	1,464,350	671,783	792,567	-	-

Total	$27,6692,206	$ 5,152,171	$ 8,356,688	$ 14,183,347	$ -

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 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, 2017, filed with the SEC on March 28, 2018 (the "2017 Form 10-K"). The Risk Factors set forth in the 2017 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 2017 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
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.

SIGNATURES

In accordance with the requirements of the Securities Exchange Act of 1934, the registrant caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

CYNERGISTEK, INC.

Date: November 8, 2018	By:	/s/ Michael McMillan Michael McMillan Chief Executive Officer (Principal Executive Officer)
Date: November 8, 2018	By:	/s/ Paul T. Anthony Paul T. Anthony Chief Financial Officer (Principal Accounting Officer)