

DATAWATCH CORP
Form 10-Q
July 25, 2016

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

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

FOR THE QUARTERLY PERIOD ENDED JUNE 30, 2016

OR

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

FOR THE TRANSITION PERIOD FROM TO

COMMISSION FILE NUMBER: 000-19960

DATAWATCH CORPORATION

(Exact name of registrant as specified in its charter)

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

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

The number of shares of the registrant's common stock, \$.01 par value, outstanding as of July 21, 2016 was 11,874,008

DATAWATCH CORPORATION

QUARTERLY REPORT ON FORM 10-Q

FOR THE QUARTERLY PERIOD ENDED JUNE 30, 2016

TABLE OF CONTENTS

	Page
Part I: <u>FINANCIAL INFORMATION</u>	1
Item 1. <u>Consolidated Financial Statements (unaudited)</u>	1
<u>Consolidated Balance Sheets as of June 30, 2016 and September 30, 2015 (unaudited)</u>	1
<u>Consolidated Statements of Operations for the Three and Nine months ended June 30, 2016 and 2015 (unaudited)</u>	2
<u>Consolidated Statements of Comprehensive Loss for the Three and Nine months ended June 30, 2016 and 2015 (unaudited)</u>	3
<u>Consolidated Statements of Cash Flows for the Nine months ended June 30, 2016 and 2015 (unaudited)</u>	4
<u>Notes to Consolidated Financial Statements (unaudited)</u>	5
Item 2. <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	15
Item 3. <u>Quantitative and Qualitative Disclosures about Market Risk</u>	24
Item 4. <u>Controls and Procedures</u>	25
Part II: <u>OTHER INFORMATION</u>	26
Item 1. <u>Legal Proceedings</u>	26
Item 1A. <u>Risk Factors</u>	26
Item 4. <u>Mine Safety Disclosures</u>	26
Item 6. <u>Exhibits</u>	27
<u>SIGNATURES</u>	28

PART I: FINANCIAL INFORMATION**ITEM 1: CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)****DATAWATCH CORPORATION****CONSOLIDATED BALANCE SHEETS (UNAUDITED)****(In thousands, except share amounts)**

	June 30, 2016	September 30, 2015
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	\$28,800	\$ 35,162
Accounts receivable, net of allowance for doubtful accounts of \$27 and \$106 as of June 30, 2016 and September 30, 2015, respectively	5,846	7,081
Prepaid expenses and other current assets	1,962	2,013
Total current assets	36,608	44,256
Property and equipment, net	1,245	614
Acquired intellectual property, net	2,494	3,981
Other intangible assets, net	1,084	1,270
Goodwill and indefinite-lived assets	6,685	6,685
Deferred tax asset, net	-	1,839
Other long-term assets	246	286
Total assets	\$48,362	\$ 58,931
LIABILITIES AND SHAREHOLDERS' EQUITY		
CURRENT LIABILITIES:		
Accounts payable	\$1,571	\$ 1,546
Accrued expenses	2,152	2,656
Deferred revenue	8,749	8,452
Deferred tax liability, current	-	274
Total current liabilities	12,472	12,928
LONG-TERM LIABILITIES:		
Deferred revenue, long-term	173	192

Edgar Filing: DATAWATCH CORP - Form 10-Q

Other long-term liabilities	522	269
Total long-term liabilities	695	461
Total liabilities	13,167	13,389

COMMITMENTS AND CONTINGENCIES (Note 6)

SHAREHOLDERS' EQUITY:

Common stock, par value \$0.01; authorized: 20,000,000 shares; issued and outstanding: 11,874,008 shares and 11,859,762 shares, respectively, as of June 30, 2016 and 11,640,097 shares and 11,625,851 shares, respectively, as of September 30, 2015	119	116
Additional paid-in capital	142,007	139,732
Accumulated deficit	(104,891)	(92,191)
Accumulated other comprehensive loss	(1,900)	(1,975)
	35,335	45,682
Less treasury stock, at cost, 14,246 shares	(140)	(140)
Total shareholders' equity	35,195	45,542
Total liabilities and shareholders' equity	\$48,362	\$58,931

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

DATAWATCH CORPORATION**CONSOLIDATED STATEMENTS OF OPERATIONS (UNAUDITED)****(In thousands, except per share amounts)**

	Three Months Ended June 30,		Nine Months Ended June 30,	
	2016	2015	2016	2015
REVENUE:				
Software licenses	\$3,669	\$4,117	\$10,461	\$11,203
Maintenance	3,335	3,311	10,417	10,016
Professional services	372	348	977	980
Total revenues	7,376	7,776	21,855	22,199
COSTS AND EXPENSES:				
Cost of software licenses	879	697	2,067	2,293
Cost of maintenance and services (1)	499	557	1,707	2,519
Sales and marketing (1)	4,773	6,513	15,621	21,303
Engineering and product development (1)	2,196	1,988	6,089	6,698
General and administrative (1)	2,593	2,204	7,453	6,779
Impairment of goodwill and long-lived assets	-	-	-	32,009
Total costs and expenses	10,940	11,959	32,937	71,601
LOSS FROM OPERATIONS	(3,564)	(4,183)	(11,082)	(49,402)
Other income	16	-	34	9
Foreign currency transaction loss	(20)	(36)	(53)	(47)
LOSS FROM OPERATIONS BEFORE INCOME TAXES	(3,568)	(4,219)	(11,101)	(49,440)
Income tax expense (benefit)	1,806	(96)	1,599	(2,632)
NET LOSS	\$(5,374)	\$(4,123)	\$(12,700)	\$(46,808)
Net loss per share – basic:	\$(0.45)	\$(0.36)	\$(1.08)	\$(4.14)
Net loss per share – diluted:	\$(0.45)	\$(0.36)	\$(1.08)	\$(4.14)
Weighted-average shares outstanding – basic	11,815	11,448	11,717	11,307
Weighted-average shares outstanding – diluted	11,815	11,448	11,717	11,307

(1) Includes share-based compensation as follows:

Edgar Filing: DATAWATCH CORP - Form 10-Q

Cost of maintenance and services	\$6	\$17	\$31	\$47
Sales and marketing	(284)	946	726	2,506
Engineering and product development	91	125	267	337
General and administrative	332	398	1,145	1,135
	\$145	\$1,486	\$2,169	\$4,025

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

2

DATAWATCH CORPORATION

CONSOLIDATED STATEMENTS OF COMPREHENSIVE LOSS (UNAUDITED)

(In thousands)

	Three Months Ended June 30,		Nine Months Ended June 30,	
	2016	2015	2016	2015
Net loss	\$ (5,374)	\$ (4,123)	\$ (12,700)	\$ (46,808)
Other comprehensive loss:				
Foreign currency translation adjustments	44	76	75	(29)
Comprehensive loss	\$ (5,330)	\$ (4,047)	\$ (12,625)	\$ (46,837)

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

DATAWATCH CORPORATION**CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)****(In thousands)**

	Nine Months Ended June 30,	
	2016	2015
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net loss	\$(12,700)	\$(46,808)
Adjustments to reconcile net loss to cash used in operating activities:		
Depreciation and amortization	1,941	2,221
Provision for doubtful accounts	(77)	-
Share-based compensation expense	2,169	4,025
Loss on disposal of fixed assets	22	-
Deferred income taxes	1,565	(2,672)
Impairment of goodwill and long-lived assets	-	32,009
Changes in operating assets and liabilities:		
Accounts receivable	1,209	568
Prepaid expenses and other assets	41	(669)
Accounts payable, accrued expenses and other liabilities	(115)	547
Deferred revenue	405	(135)
Cash used in operating activities	(5,540)	(10,914)
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchases of property and equipment	(925)	(400)
Cash used in investing activities	(925)	(400)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Proceeds from exercise of stock options	109	58
Cash provided by financing activities	109	58
EFFECT OF EXCHANGE RATE CHANGES ON CASH AND CASH EQUIVALENTS	(6)	(93)
DECREASE IN CASH AND CASH EQUIVALENTS	(6,362)	(11,349)
CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD	35,162	47,668
CASH AND CASH EQUIVALENTS, END OF PERIOD	\$28,800	\$36,319

SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:

Income taxes paid	\$16	\$38
-------------------	------	------

These notes are an integral part of the consolidated financial statement

4

DATAWATCH CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(UNAUDITED)

NOTE 1. DESCRIPTION OF BUSINESS

Datawatch Corporation (the “Company” or “Datawatch”) provides self-service data preparation and visual data discovery software that optimizes multiple sources and a variety of data – regardless of its variety, volume, or velocity – delivering next generation analytics to reveal valuable insights for improving business processes. Its ability to integrate structured, unstructured, and semi-structured sources like reports, PDF files and EDI streams with real-time streaming data into visually rich analytic applications allows users to dynamically discover key factors that impact any operational aspect of their business. The Company believes this ability to perform visual discovery against multiple sources and a variety of data sets Datawatch apart in the Big Data and visualization markets. Organizations of every size, worldwide use Datawatch products.

NOTE 2. BASIS OF PRESENTATION

The accompanying unaudited consolidated financial statements include the accounts of Datawatch and its wholly-owned subsidiaries and have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission (the “SEC”) regarding interim financial reporting. Accordingly, they do not include all of the information and notes required by accounting principles generally accepted in the United States of America (“U.S. GAAP”) for complete financial statements and should be read in conjunction with the audited consolidated financial statements included in the Company’s Annual Report on Form 10-K for the year ended September 30, 2015 filed with the SEC. All intercompany accounts and transactions have been eliminated in consolidation.

In the opinion of management, the accompanying consolidated financial statements have been prepared on the same basis as the audited consolidated financial statements for the fiscal year ended September 30, 2015, and include all adjustments necessary for fair presentation of the results of the interim periods presented. The operating results for the interim periods presented are not necessarily indicative of the results expected for the full year. The Company considers events or transactions that occur after the balance sheet date but before the financial statements are issued to provide additional evidence relative to certain estimates or to identify matters that require additional disclosure.

NOTE 3. FAIR VALUE MEASUREMENTS

The Company's financial instruments consist of cash and cash equivalents, accounts receivable and accounts payable. The estimated fair values have been determined through information obtained from market sources and management estimates. The estimated fair value of certain financial instruments including cash and cash equivalents, accounts receivable and accounts payable, approximate the carrying value due to their short-term maturity.

The fair value of the Company's financial assets and liabilities are measured using inputs from the three levels of fair value hierarchy which are as follows:

- Level 1 — Quoted prices in active markets for identical assets or liabilities;

- Level 2 — Inputs other than Level 1 that are observable, either directly or indirectly, such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities; and

- Level 3 — Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities.

The Company classified its cash equivalents, which primarily include money market mutual funds of \$18.8 million and \$25.7 million as of June 30, 2016 and September 30, 2015, respectively, within Level 2 of the fair value hierarchy.

As of June 30, 2016 and September 30, 2015, the Company's assets that are measured on a recurring basis and whose carrying values approximate their respective fair values include the following (in thousands):

	June 30, 2016			September 30, 2015		
	Fair Value Measurement Using Input Types			Fair Value Measurement Using Input Types		
	Level 1	Level 2	Level 3	Level 1	Level 2	Level 3
Assets:						
Money market funds	\$ -	\$ 18,756	\$ -	\$ -	\$ 25,724	\$ -
Total	\$ -	\$ 18,756	\$ -	\$ -	\$ 25,724	\$ -

Non-financial assets such as goodwill and long-lived assets are also subject to non-recurring fair value measurements if they are deemed to be impaired. The impairment models used for nonfinancial assets depend on the type of asset and are accounted for in accordance with the Financial Accounting Standards Board ("FASB") guidance on fair value measurement. The fair value measurements for these non-financial assets were calculated using a discounted cash flow approach, which includes unobservable inputs classified as Level 3 within the fair value hierarchy. See Note 4 for additional discussion regarding the fair value methods used for these assets. The amount and timing of future cash flows was based on the Company's most recent operational forecasts. The Company uses the assistance of an independent consulting firm to develop valuation assumptions. See Notes 4 and 5 for additional discussion regarding the impairment of goodwill and long-lived assets.

NOTE 4: IMPAIRMENT OF GOODWILL AND INDEFINITE-LIVED ASSETS

Goodwill represents the excess of the purchase price over the fair value of identifiable net assets of acquired businesses. Indefinite-lived intangibles are intangible assets whose useful lives are indefinite in that their lives extend beyond the foreseeable horizon – that is there is no foreseeable limit on the period of time over which they are expected to contribute to the cash flows of the reporting entity. The Company accounts for these items in accordance with Accounting Standards Codification ("ASC") 350 *Intangibles – Goodwill and Other*, which requires that impairment testing for goodwill is performed at least annually at the reporting unit level. A reporting unit is an operating segment or one level below an operating segment (also known as a component). The Company has determined that it is comprised of only one reporting unit. The Company performs its annual impairment test as of July 31st. Goodwill is also tested for impairment between annual tests if an event occurs or circumstances change that would more likely than not reduce the fair value of a reporting unit below its carrying value. Examples of these events or circumstances include:

A significant adverse long term outlook;

Edgar Filing: DATAWATCH CORP - Form 10-Q

Unanticipated competition or the introduction of a disruptive technology;

Failure of an anticipated product or product line;

The testing for recoverability under the ASC 360-10 *Impairment or Disposal of Long-Lived Assets* of a significant asset group;

A loss of key personnel; and

An expectation that a significant portion of the Company will be sold or otherwise disposed of.

The impairment test for goodwill uses a two-step approach. Step one compares the fair value of the reporting unit to its carrying value including goodwill. If the carrying value exceeds the fair value, there is a potential impairment and step two must be performed. Step two compares the carrying value of the reporting unit's goodwill to its implied value (i.e., the fair value of the reporting unit less the fair value of the unit's assets and liabilities, including identifiable intangible assets). If the carrying value of goodwill exceeds its implied value, the excess is recorded as an impairment.

During the three months ended December 31, 2014, the Company identified several events, that when combined, were determined to require an interim impairment test. These events consisted of a material decrease in revenue compared to prior year and compared to the prior quarter which resulted in a decision to pre-release earnings information; necessary operational changes within the Sales Organization which drove a shift in our sales approach; and a sustained decrease in share price.

Under Step 1 of the impairment test the Company determined fair value based on discounted cash flows using an income approach with the multi-period excess earnings method which estimates the fair value of the asset by discounting the future projected excess earnings associated with the asset to present value as of the valuation date. Based on the analysis, it was determined that the carrying value of the Company including goodwill exceeded the fair value, requiring the Company to perform Step 2 of the goodwill impairment test to measure the amount of impairment loss, if any.

The Company then performed Step 2 of the impairment test, noting fair value of the long-lived assets (other than goodwill), of \$3.0 million, was less than the carrying amount of those assets and, as a result, recorded a non-cash, pre-tax impairment charge of \$10.3 million during the three months ended December 31, 2014 (see Note 5). The Company then determined the implied value of goodwill was \$6.7 million, which was less than its carrying value and, as a result, the Company recognized a non-cash, pre-tax charge of \$21.7 million during the three months ended December 31, 2014. These impairment charges are included under the caption "Impairment of goodwill and long-lived assets" in our consolidated statements of operations. There were no impairment charges recognized during the three and nine months ended June 30, 2016.

The valuation methods utilized to value the long-lived assets and the goodwill discussed above are based on the amount and timing of expected future cash flows and growth rates and include a determination of an appropriate discount rate. The cash flows utilized in the discounted cash flow analyses were based on financial forecasts developed internally by management. Estimating future cash flows requires significant judgment and projections may vary from the cash flows eventually realized. Determining the fair value using a discounted cash flow method requires significant estimates and assumptions, including market conditions, discount rates, and long-term projections of cash flows. The Company's estimates are based upon historical experience, current market trends, projected future volumes and other information. The Company believes that the estimates and assumptions underlying the valuation methodology are reasonable; however, different estimates and assumptions could result in a different estimate of fair value. In estimating future cash flows, the Company relies on internally generated projections for a defined time period for revenue and operating profits, including capital expenditures, changes in net working capital, and adjustments for non-cash items to arrive at the free cash flow available to invested capital. Where applicable, a terminal value utilizing a constant growth rate of cash flows is used to calculate a terminal value after the explicit projection period. The future projected cash flows for the discrete projection period and the terminal value are discounted at a risk adjusted discount rate to determine the fair value of the reporting unit.

The following table presents the changes in the carrying amount of our goodwill (in thousands):

Balance at September 30, 2014	\$28,383
Goodwill impairment	(21,698)
Balance at September 30, 2015	6,685
Goodwill impairment	-
Balance at June 30, 2016	\$6,685

NOTE 5: LONG-LIVED ASSETS

Intangible assets are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of the asset may not be recoverable and an impairment loss is recognized when it is probable that the estimated cash flows are less than the carrying amount of the asset.

During the three months ended December 31, 2014, as a result of an interim impairment test of goodwill and long-lived assets (see Note 4), the Company recorded an impairment charge of \$4.9 million for the intellectual property acquired from Panopticon and \$5.4 million for the customer lists acquired from Panopticon. There were no impairment charges recognized for the three and nine months ended June 30, 2016.

Acquired Intellectual Property

Acquired intellectual property consists of software source code acquired through business combinations in prior years. The acquired intellectual property assets are being amortized to cost of software licenses using the straight-line method over the estimated life of the asset, ranging from five to seven and a half years.

Acquired intellectual property, net, were comprised of the following at June 30, 2016 and September 30, 2015 (in thousands):

June 30, 2016					
Identified Intangible Asset	Weighted Average Useful Life (In years)	Gross Carrying Amount	Impairment	Accumulated Amortization	Net Carrying Amount
Panopticon intellectual property	7.5	\$7,900	\$ (4,895)	\$ (1,794)	\$ 1,211
Monarch intellectual property	5	8,616	-	(7,333)	1,283
Total		\$ 16,516	\$ (4,895)	\$ (9,127)	\$ 2,494

September 30, 2015					
Identified Intangible Asset	Weighted Average Useful Life	Gross Carrying Amount	Impairment	Accumulated Amortization	Net Carrying Amount

(In
years)

Panopticon intellectual property	7.5	\$ 7,900	\$ (4,895) \$ (1,599) \$ 1,406
Monarch intellectual property	5	8,616	-	(6,041) 2,575
Total		\$ 16,516	\$ (4,895) \$ (7,640) \$ 3,981

Other Intangible Assets

Other intangible assets consist of trade names, patents and customer lists acquired through business combinations in prior years. The values allocated to these intangible assets are amortized using the straight-line method over the estimated useful life of the related asset.

Other intangible assets, net, were comprised of the following at June 30, 2016 and September 30, 2015 (in thousands):

June 30, 2016

Identified Intangible Asset	Weighted Average Useful Life (In years)	Gross Carrying Amount	Impairment	Accumulated Amortization	Net Carrying Amount
Patents	20	\$ 160	\$ -	\$ (94)	\$ 66
Customer lists	14	8,990	(5,416)	(2,556)	1,018
Trade names	3	120	-	(120)	-
Total		\$ 9,270	\$ (5,416)	\$ (2,770)	\$ 1,084

September 30, 2015

Identified Intangible Asset	Weighted Average Useful Life (In years)	Gross Carrying Amount	Impairment	Accumulated Amortization	Net Carrying Amount
Patents	20	\$ 160	\$ -	\$ (88)	\$ 72
Customer lists	14	8,990	(5,416)	(2,396)	1,178
Trade names	3	120	-	(100)	20
Total		\$ 9,270	\$ (5,416)	\$ (2,584)	\$ 1,270

NOTE 6. COMMITMENTS AND CONTINGENCIES

Leases

The Company leases various facilities and equipment in the U.S. and overseas under non-cancelable operating leases which expire at various dates through 2022. The lease agreements generally provide for the payment of minimum annual rentals and pro-rata share of taxes and maintenance expenses. Rental expense for all operating leases was \$0.3 million for both the three months ended June 30, 2016 and 2015, and \$0.8 million for both the nine months ended

June 30, 2016 and 2015.

On June 23, 2015, the Company entered into a facility lease in Bedford, MA for a new corporate headquarters. The lease is for 20,360 square feet and has a term of 84 months which commenced in January 2016 when the Company moved in. The monthly rent expense is \$42,000. In conjunction with entering into the lease, the Company was required to deposit \$0.2 million into a restricted cash account as collateral for a Letter of Credit, which is included under the caption "Other long-term assets" in our consolidated balance sheets, at June 30, 2016. Deferred rent of \$0.2 million is included under the caption "Other long-term liabilities" in our consolidated balance sheets, at June 30, 2016. There was no deferred rent at September 30, 2015. Certain of the Company's facility leases include options to renew.

Royalties

Royalty expense included in cost of software license was \$0.3 million and \$0.2 million for the three months ended June 30, 2016 and 2015, respectively, and was \$0.4 million for both the nine months ended June 30, 2016 and 2015. Minimum royalty obligations were insignificant for the three and nine months ended June 30, 2016 and 2015.

Contingencies

From time to time, the Company is subject to claims and may be party to actions that arise in the normal course of business. The Company is not party to any litigation that management believes will have a material adverse effect on the Company's consolidated financial condition or results of operations.

NOTE 7. RESTRUCTURING CHARGES

During the nine months ended June 30, 2015, the Company undertook restructuring efforts to (i) lower expenses by reducing the investment in legacy solutions and realigning of international operations, primarily impacting engineering and product development, and (ii) further reduce the workforce across all functional areas of the Company in an effort to rebalance investments to match the go-to-market model. The restructuring efforts began during the quarter ended December 31, 2014 and continued during the quarter ended March 31, 2015, when the remaining employees impacted by the restructuring were notified. The Company recorded restructuring charges of \$0.4 million during the three months ended December 31, 2014 and an additional \$1.2 million during the three months ended March 31, 2015 including severance and related benefit costs related to workforce reductions. The Company completed all restructuring actions associated with these plans during the fiscal year ended September 30, 2015.

The Company did not undertake any restructuring efforts during fiscal 2016. However, the Company recorded severance expense of \$0.3 million and \$0.6 million for the three and nine months ended June 30, 2016, respectively.

The following table presents the changes in the accrual for restructuring and severance charges, which is included under the caption “Accrued expenses” in our consolidated balance sheets, as of June 30, 2016 and September 30, 2015 (in thousands):

Balance at September 30, 2014	\$-
Charges	1,786
Payments	(1,555)
Balance at September 30, 2015	231
Charges	561
Payments	(618)
Balance at June 30, 2016	\$ 174

The following table presents restructuring and severance charges included in our unaudited consolidated statements of operations (in thousands):

	Three Months	Nine Months Ended
--	-----------------	----------------------

Edgar Filing: DATAWATCH CORP - Form 10-Q

	Ended		June 30,	
	June 30,	June 30,	2016	2015
	2016	2015	2016	2015
Cost of maintenance and services	\$7	\$(14)	\$57	\$365
Sales and marketing	248	31	482	716
Engineering and product development	16	11	20	323
General and administrative	-	1	2	236
	\$271	\$29	\$561	\$1,640

NOTE 8. INCOME TAXES

During the three and nine months ended June 30, 2016, the Company recorded a tax expense of \$1.8 million and \$1.6 million, respectively, primarily related to the change in valuation allowance against Swedish tax assets, estimated state taxes, and accruing interest on uncertain tax positions. During the three months ended June 30, 2015, the Company recorded a tax benefit of \$0.1 million, primarily related to the change in the deferred tax asset in Sweden as a result of generating losses, estimated state taxes, return to provision adjustments, and accrued interest on uncertain tax positions. During the nine months ended June 30, 2015, the Company recorded a tax benefit of \$2.6 million, primarily related to the change in the deferred tax liability in Sweden as a result of impairing non-goodwill intangibles and amortization, estimated state taxes, and accrued interest on uncertain tax positions.

The Company's deferred tax assets include net operating loss carry forwards and tax credits that expire at different times through 2035. ASC Topic 740, *Income Taxes*, requires that all available evidence, both positive and negative, be considered in determining, based on the weight of that evidence, whether a valuation allowance is appropriate. The weight given to the potential effect of negative and positive evidence should be commensurate with the extent to which such evidence can be objectively verified. The more negative evidence that exists, the more positive evidence is necessary, and the more difficult it is, to support a conclusion that a valuation allowance is not appropriate for some portion or all of the deferred tax asset. A cumulative loss in recent years is considered a significant piece of negative evidence that is difficult to overcome in assessing the need for a valuation allowance.

The Company evaluates the realizability of its deferred tax assets by each tax jurisdiction and assesses the need for a valuation allowance in such tax jurisdictions on a quarterly basis. The Company evaluates the profitability of each tax jurisdiction on a historic cumulative basis and on a forward-looking basis in the course of performing this analysis. The Company has evaluated all positive and negative evidence in concluding it is appropriate to continue to maintain a full valuation allowance on its deferred tax assets in the United States, Australia, United Kingdom, Germany, and Singapore. In addition, the Company has concluded that it is appropriate to establish a full valuation allowance against its net deferred tax assets in Sweden during the three months ended June 30, 2016.

The Company evaluated negative evidence to assess if it is more likely than not that the Company could make use of its deferred tax assets. The Company is in a cumulative loss position in all tax jurisdictions in which it currently has operations and has no ability to carry back any of those losses. The reversal of temporary differences in each respective tax jurisdiction will not generate sufficient income to enable the Company to use its deferred tax assets in those jurisdictions. The Company anticipates that it will continue to generate losses in all of the tax jurisdictions in which it operates for the foreseeable future.

The Company also considered positive evidence, such as expected growth in its business. Prior to the third quarter of fiscal 2016, the Company projected that its operations in Sweden in future years would generate sufficient income to

be able to fully utilize its losses in Sweden. Upon review and analysis of recently provided sales data, the Company re-evaluated its projected income and believes that the Sweden operations may generate less income in the foreseeable future than previously projected. As a result of this change in assessment and revised projections, the Company has determined that it is appropriate to establish a valuation allowance on its deferred tax assets in Sweden during the three months ended June 30, 2016. The Company will continue to maintain a full valuation allowance on its net deferred tax assets in the United States, Australia, United Kingdom, Germany, and Singapore until there is sufficient positive evidence to support the reversal of all or some portion of these allowances.

At September 30, 2015, the Company had a cumulative tax liability of \$0.3 million related to uncertain tax positions for Federal, state, and foreign tax exposure that could result in cash payments. There were no significant changes to the Company's uncertain tax positions during the three and nine months ended June 30, 2016.

NOTE 9. CALCULATION OF NET LOSS PER SHARE

Basic net loss per share is computed by dividing net loss by the weighted-average number of common shares outstanding. Diluted net loss per share is computed by dividing net loss by the weighted-average number of common shares outstanding plus additional common shares that would have been outstanding if dilutive potential common shares had been issued. For the purposes of this calculation, stock options are considered common equivalents in periods in which they have a dilutive effect. Stock options that are anti-dilutive are excluded from the calculation.

The following table presents the computation of basic and diluted net loss per share (in thousands, except per share data):

	Three Months Ended		Nine Months Ended	
	June 30, 2016	2015	June 30, 2016	2015
Net loss	\$(5,374)	\$(4,123)	\$(12,700)	\$(46,808)
Weighted-average number of common shares outstanding	11,815	11,448	11,717	11,307
Net loss per share	\$(0.45)	\$(0.36)	\$(1.08)	\$(4.14)

For the three and nine months ended June 30, 2016 and 2015 all common stock were anti-dilutive as a result of the Company's net loss position. As such, 389,373 shares and 242,200 shares, have not been included in the calculation of basic or diluted net loss per share, for the three months ended June 30, 2016 and 2015, respectively, and 398,725 shares and 272,700 shares, have not been included in the calculation of basic or diluted net loss per share, for the nine months ended June 30, 2016 and 2015, respectively.

NOTE 10. SHARE-BASED COMPENSATION

The Company provides its employees, officers, consultants and directors with stock options, restricted stock units and other stock rights for common stock of the Company on a discretionary basis. All option and restricted stock unit grants are subject to the terms and conditions determined by the Compensation and Stock Committee of the Board of Directors, and generally vest over a three-year period beginning three months from the date of grant and expire either seven or ten years from the date of grant. All awards granted during the nine months ended June 30, 2016 were granted under our Second Amended and Restated Equity Compensation and Incentive Plan (the "2011 Plan"). At June 30, 2016, there were 266,904 shares available for future issuance under the 2011 Plan.

Generally, stock options are granted at exercise prices not less than the fair market value at the date of grant. All of the Company's share-based awards are accounted for as equity instruments and there have been no liability awards granted. Share-based compensation expense for share-based payment awards, issued to employees and directors, is measured based on the grant-date fair value of the award and recognized on a straight-line basis over the requisite period of the award. Share-based compensation expense for share-based payment awards, issued to non-employees, is revalued each fiscal, quarter based on the current fair value of the award, and recognized on over the requisite period of the award.

Stock Options

The Company estimates the fair value of each stock option grant using the Black-Scholes option valuation model. The Black-Scholes option valuation model incorporates assumptions as to stock price volatility, the expected life of options, a risk-free interest rate and dividend yield.

The following table is a summary of combined activity for all of the Company's stock options:

	Number of Options	Weighted- Average Exercise Price Per Share	Weighted- Average Remaining Life (In years)	Aggregate Intrinsic Value (In thousands)
Outstanding, September 30, 2015	302,500	\$ 6.15	2.86	\$ 446
Granted	-	-	-	-
Canceled/Forfeited	(5,000)	3.61	-	7
Exercised	(22,500)	4.73	1.00	15
Outstanding, June 30, 2016	275,000	\$ 6.31	2.26	\$ 341
Exercisable, June 30, 2016	275,000	\$ 6.31	2.26	\$ 341
Unvested awards expected to vest, June 30, 2016	-	\$ -	-	\$ -

Restricted Stock Units

The fair value related to the restricted stock units ("RSUs") issued to employees and directors, is calculated based on the closing stock price of the Company's common stock on the date of the grant and is amortized ratably over the vesting period of the award. The fair value related to the restricted stock units ("RSUs") issued to non-employees, is revalued each fiscal quarter, based on the current closing stock price of the Company's common stock, and is amortized ratably over the vesting period of the award.

The following table presents nonvested RSU information for the nine months ended June 30, 2016:

	Number of RSUs Outstanding
Nonvested, September 30, 2015	569,564
Granted	401,800
Canceled/Forfeited	(176,364)
Vested	(213,911)

Nonvested, June 30, 2016

581,089

NOTE 11. SEGMENT INFORMATION AND REVENUE BY GEOGRAPHIC LOCATION

The Company operates its business as one operating segment and has determined that it has only one reportable segment. The Company's chief operating decision maker, its Chief Executive Officer, does not manage any part of the Company separately, and the allocation of resources and assessment of performance is based solely on the Company's consolidated operations and operating results.

The Company conducts operations domestically and internationally. The following table presents information about the Company's geographic operations (in thousands):

	Domestic	International	Total
Total Revenue			
Three months ended June 30, 2016	\$6,175	\$ 1,201	\$7,376
Three months ended June 30, 2015	\$6,183	\$ 1,593	\$7,776
Nine months ended June 30, 2016	\$18,698	\$ 3,157	\$21,855
Nine months ended June 30, 2015	\$17,487	\$ 4,712	\$22,199
Total Operating Loss			
Three months ended June 30, 2016	\$(2,671)	\$ (893)	\$(3,564)
Three months ended June 30, 2015	\$(2,798)	\$ (1,385)	\$(4,183)
Nine months ended June 30, 2016	\$(8,229)	\$ (2,853)	\$(11,082)
Nine months ended June 30, 2015	\$(44,070)	\$ (5,332)	\$(49,402)
Total Long-Lived Assets			
At June 30, 2016	\$11,673	\$ 81	\$11,754
At September 30, 2015	\$14,515	\$ 160	\$14,675

NOTE 12. RECENT ACCOUNTING PRONOUNCEMENTS

In March 2016, the FASB issued Accounting Standard Update ("ASU") 2016-09, *Improvements to Employee Share-Based Payment Accounting*, which is intended to simplify various aspects of how share-based payments are accounted for and presented in financial statements. The standard is effective prospectively for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2017, with early adoption permitted. The Company is currently evaluating the effect this standard will have on the Company's consolidated financial statements and related disclosures.

In February 2016, the FASB issued ASU 2016-02, *Leases (Topic 842)*, which requires lessees to recognize, on the balance sheet, leases with a lease terms of greater than twelve months as a right-of-use asset and a lease liability. The standard is effective for fiscal years beginning after December 15, 2018. The Company is currently evaluating the effect that the standard will have on the Company's consolidated financial statements and related disclosures.

In November 2015, the FASB issued ASU 2015-17, *Balance Sheet Classification of Deferred Taxes*, which requires that deferred tax liabilities and assets be classified as noncurrent in a classified statement of financial position to simplify the presentation of deferred income taxes. The standard is effective prospectively for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2017, with early adoption permitted. As of October 1, 2015, the Company elected to adopt early the pronouncement on a prospective basis. Adoption of this amendment did not have an effect on the Company's financial position or results of operations, and prior periods were not retrospectively adjusted.

In May 2014, the FASB issued ASU 2014-09, *Revenue from Contracts with Customers (Topic 606)*. The ASU is the result of a joint project by the FASB and the International Accounting Standards Board ("IASB") to clarify the principles for recognizing revenue and to develop a common revenue standard for GAAP and International Financial Reporting Standards ("IFRS") that would: remove inconsistencies and weaknesses, provide a more robust framework for addressing revenue issues, improve comparability of revenue recognition practices across entities, jurisdictions, industries, and capital markets, improve disclosure requirements and resulting financial statements, and simplify the presentation of financial statements. The core principle of the new guidance is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. The ASU was initially effective for annual reporting periods beginning after December 15, 2016. On July 9, 2015, the FASB voted to delay the effective date of the new revenue standard by one year, but to permit entities to choose to adopt the standard as of the original effective date. The Company is currently evaluating the effect that the updated standard will have on the Company's consolidated financial statements and related disclosures.

The Company has considered all other recently issued accounting pronouncements and does not believe the adoption of such pronouncements will have a material impact on its consolidated financial statements.

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

General

We do not provide forecasts of our future financial performance. However, from time to time, information we provide or statements made by our employees may contain "forward looking" information that involves risks and uncertainties. In particular, statements contained in this Quarterly Report on Form 10-Q that are not historical facts may constitute forward looking statements and are made under the safe harbor provisions of The Private Securities Litigation Reform Act of 1995. We caution readers not to place undue reliance on any such forward looking statements, which speak only as of the date they are made. We disclaim any obligation, except as specifically required by law and the rules of the Securities and Exchange Commission, to publicly update or revise any such statements to reflect any change in our expectations or in events, conditions or circumstances on which any such statements may be based, or that may affect the likelihood that actual results will differ from those set forth in the forward looking statements. Our actual results of operations and financial condition have varied and may in the future vary significantly from those stated in any forward looking statements. Factors that may cause such differences include, without limitation, the risks, uncertainties and other information discussed in Item 1A of our Annual Report on Form 10-K for the fiscal year ended September 30, 2015, and in Item 1A of Part II of this Quarterly Report on Form 10-Q, as well as the accuracy of our internal estimates of revenue and operating expense levels.

Introduction

We are engaged in the design, development, marketing, distribution and support of business computer software primarily for the visual data discovery and self-service data preparation markets to allow organizations to access, analyze and visualize information in a more meaningful fashion. The Datawatch Managed Analytics Platform is an enterprise solution that bridges the gap between the ease-of-use and agility that business users demand together with the scalability, automation and governance needed by IT.

Our principal product line of Managed Analytics Platform solutions includes the following products:

·Datawatch Designer™ — Visually Design, Discover and Explore New Insights

Datawatch Designer lets users quickly start asking questions to see hidden patterns, spot problems and identify missed opportunities without programming or scripting. Our in-memory analytics engine enables on-the-fly aggregations and intuitive navigation and integration of data from virtually any data source. With a simple drag-and-drop interface, users can set up hierarchies and filters in their dashboards to make it easier to spot outliers and to see how different subsets of data correlate with each other. Datawatch Designer provides a range of specialized visualizations designed specifically to make analyzing streaming data, time series data and historical data, more impactful. Integrated data preparation capabilities and pre-built connectors make it simple to access and combine information from any data source, including data streams from message brokers and complex event processing engines.

· **Datawatch Monarch™ — Capture and Transform Data from Virtually Any Source**

Datawatch Monarch is a self-service data preparation tool which lets users explore, manipulate and merge new data sources. With Datawatch Monarch, users can bring all the data that is needed to manage the business to life, whether that information is stored in structured sources like databases, or in less conventional places like unstructured or semi-structured EDI streams, PDF files, reports, or text files.

· **Datawatch Server™ — Securely Share, Visualize Throughout the Organization**

To fully exploit the power of optimized information, organizations must ensure that all information is easily available to users of all types. Datawatch Server is used to automate, manage, store and visualize information from any data source that can be modeled via the Datawatch Designer or Datawatch Monarch products.

· **Datawatch Report Mining Server™ — Unlocking the Power of Content**

Datawatch Report Mining Server (“RMS”) is a web-based report analytics solution that integrates with any existing enterprise content management system such as Datawatch Report Manager On-Demand, IBM Content Manager On-Demand, Microsoft SharePoint, Hyland OnBase, ASG Mobius ViewDirect and others. Datawatch RMS opens up the corporate data locked in content management systems, static reports and business documents, enabling dynamic business-driven analysis of information using Datawatch Designer or other productivity tools with no user programming.

CRITICAL ACCOUNTING POLICIES

The Securities and Exchange Commission (“SEC”) issued disclosure guidance for “critical accounting policies.” The SEC defines “critical accounting policies” as those that require the application of management’s most difficult, subjective or complex judgments, often as a result of the need to make estimates about the effect of matters that are inherently uncertain and may change in subsequent periods.

Our significant accounting policies are described in Note 1 to the consolidated financial statements for the fiscal year ended September 30, 2015 included in our previously filed Form 10-K. There have been no material changes to the accounting policies for the three and nine months ended June 30, 2016.

OVERVIEW

During the third quarter of fiscal 2016, we added 228 new customers for our Monarch data preparation solution, which was an increase of 28% over the number of new Monarch customers added in the second quarter of fiscal 2016. Two important operational metrics are the number of six-figure deals and the average deal size for license sales greater than \$10,000. The number of six-figure deals decreased from ten deals for the three months ended June 30, 2015 to three deals for three months ended June 30, 2016. The average deal size for license sales greater than \$10,000 decreased approximately 37% from \$56,000 for the three months ended June 30, 2015 to \$35,000 for the three months ended June 30, 2016.

Sales execution

Overall revenue decreased by \$0.4 million compared to the same quarter last fiscal year; however, our deferred revenue increased by \$1.6 million as of June 30, 2016 compared to the end of the same quarter last fiscal year. Of the total deferred revenue increase, deferred license revenue increased by \$1.2 million, almost 160%, as a direct result of a pricing change implemented during the second half of fiscal 2015. This pricing change requires all new or non-current maintenance customers purchasing less than 10 seats of Monarch, to purchase term licenses instead of perpetual licenses. In addition, license subscription bookings continue to increase quarter-over-quarter. License subscription bookings increased \$0.3 million, or 41%, over the quarter ended March 31, 2016 to an all-time high of \$1.1 million for the quarter ended June 30, 2016. We recognized more than \$0.7 million in subscription license revenue for the quarter ended June 30, 2016 representing an annual run rate of approximately \$3.0 million.

Market awareness

During the quarter ended June 30, 2016, we completed a six-figure Monarch upgrade transaction with one of the Big Four public accounting firms. This longstanding customer of our heritage product was able to quickly develop a compelling return-on-investment with the added value of our next generation Monarch offering because of its intuitiveness, ease-of-use and self-service capabilities, and upgraded its existing 3,000 users, while also licensing several thousand additional users.

Our partner relationship with IBM achieved an important milestone in mid-May when our Monarch self-service data preparation offering was officially added to IBM's price list to complement both IBM Watson Analytics and IBM Cognos Analytics, making it available to thousands of IBM sales people and partners for resale. In the ensuing weeks, we have worked with IBM to develop a very healthy pipeline of opportunities, and we are focused on continuing to grow this pipeline of business and convert initial deals as quickly as possible.

We continue to make inroads in the Tableau partner ecosystem as the cost-effective data preparation solution for Tableau's market-leading self-service analytics. During the quarter ended June 30, 2016, in the Asia-Pacific region alone, we teamed with six new partners that are all Tableau resellers. Several of these new resellers selected us over competing data preparation solutions, due to our tight integration with Tableau, our ease-of-use, rich functionality and our attractive price point.

Innovation to product platform

During the quarter ended June 30, 2016, we released Datawatch Panopticon 13.7 which provides faster visual data analysis for trading, risk and compliance markets. The new powerful features enable buy-side and sell-side securities firms and exchanges to perform Big Data analysis of e-trading data in real-time, intra-day and historically in order to gain insights that speed decision making. Datawatch Panopticon 13.7 introduces new visualizations, predictive analytics and Big Data connectivity capabilities, all of which empower users to monitor data, investigate historical performance and instantly take action to improve business profitability. From analytical dashboard design and publishing, to secure access through a web browser, users are able to access an unprecedented view of their operational data. The software allows users to easily transition from order execution monitoring and analysis, to drilling into execution history and reviewing historic order flow.

RESULTS OF OPERATIONS

Edgar Filing: DATAWATCH CORP - Form 10-Q

The following table sets forth certain statements of operations data as a percentage of total revenues for the periods indicated. The data has been derived from our accompanying consolidated financial statements. The operating results for any period should not be considered indicative of the results expected for any future period.

	Three Months Ended June 30, 2016		Nine Months Ended June 30, 2015	
REVENUE:				
Software licenses	50 %	53 %	48 %	51 %
Maintenance	45	43	48	45
Professional services	5	4	4	4
Total revenues	100%	100 %	100%	100 %
COSTS AND EXPENSES:				
Cost of software licenses	12 %	9 %	9 %	10 %
Cost of maintenance and services	7	7	8	11
Sales and marketing	65	84	71	96
Engineering and product development	30	26	28	30
General and administrative	35	28	34	31
Impairment of goodwill and long-lived assets	-	-	-	144
Total costs and expenses	149%	154 %	150%	322 %
LOSS FROM OPERATIONS	(49)%	(54)%	(50)%	(222)%
Other income	-	-	-	-
Foreign currency transaction loss	-	-	-	-
LOSS FROM OPERATIONS BEFORE INCOME TAXES	(49)%	(54)%	(50)%	(222)%
Income tax expense (benefit)	24	(1)	7	(12)
NET LOSS	(73)%	(53)%	(57)%	(210)%

Three Months Ended June 30, 2016 Compared to**Three Months Ended June 30, 2015****Total Revenues**

	Three Months Ended		Increase (Decrease)	Percentage Change
	June 30, 2016	2015		
Software licenses	\$ 3,669	\$ 4,117	\$ (448)	(11)%
Maintenance	3,335	3,311	24	1
Professional services	372	348	24	7
Total revenue	\$ 7,376	\$ 7,776	\$ (400)	(5)%

Software license revenue. Software license revenue decreased \$0.4 million when compared with revenue for the three months ended June 30, 2015. During the second half of fiscal 2015, we implemented a change in our pricing practice for Monarch requiring all new or non-current maintenance customers purchasing fewer than ten seats of Monarch, to purchase term licenses instead of perpetual licenses. The decrease in software license revenue was due to a decrease in perpetual software license revenue of \$1.1 million, caused in part by the pricing change, offset by an increase in subscription license revenue of \$0.6 million compared to the three months ended June 30, 2015. Since this pricing change went into effect, we have observed the continued growth of our deferred revenue related to subscription software, which we believe will translate into software license revenue in future quarters. Overall our deferred revenue increased by \$1.6 million as of June 30, 2016 compared to the end of the same quarter last fiscal year. Of the total deferred revenue increases, deferred license revenue increased \$1.2 million, almost 160%, as a direct result of the pricing change.

Maintenance revenue. Maintenance revenue remained relatively flat compared to the same quarter last fiscal year.

Professional services. Professional services revenue remained relatively flat compared to the same quarter last fiscal year.

Total Costs and Expenses

	Three Months Ended		Increase (Decrease)	Percentage Change	
	June 30, 2016	2015			
Cost of software licenses	\$ 879	\$ 697	\$ 182	26	%
Cost of maintenance and services	499	557	(58)	(10)	
Sales and marketing	4,773	6,513	(1,740)	(27)	
Engineering and product development	2,196	1,988	208	10	
General and administrative	2,593	2,204	389	18	
Total costs and operating expenses	\$ 10,940	\$ 11,959	\$ (1,019)	(9)	%

Cost of software licenses. The \$0.2 million increase was primarily driven by increased royalties as a result of a large six-figure transaction which was our first major customer upgrade to Monarch Complete.

Cost of maintenance and services. The \$0.1 million decrease was primarily driven by workforce reductions that occurred during the prior fiscal year. As a result of the workforce reductions that occurred during the prior fiscal year, employee related expenses, such as salaries, payroll taxes and benefits decreased by \$0.1 million, for the three months ended June 30, 2016 when compared to the same quarter last fiscal year.

Sales and marketing expenses. The \$1.7 million decrease in sales and marketing expenses was comprised of a decrease in sales expense of \$2.0 million offset by an increase in marketing expense of \$0.3 million. The decreased sales expense was primarily driven by decreased share-based compensation and the workforce reductions which occurred during the prior fiscal year. Share-based compensation decreased \$1.0 million as a result of numerous factors, including a \$0.4 million decrease due to the reduction in headcount, a decrease of \$0.3 million due to the departure of our Chief Revenue Officer and a \$0.3 million reversal of previously recorded share-based compensation related to consultants. As a result of the workforce reductions that occurred during the prior fiscal year, employee related expenses, such as salaries, payroll taxes and benefits decreased \$0.8 million and travel related expenses decreased \$0.1 million. In addition to the share-based compensation expense and the decreased employee related expenses resulting from the workforce reductions, there was also a \$0.3 million decrease in spending related to outside consultants. These decreases in expense compared to the same quarter in the prior fiscal year, were offset by a \$0.2 million increase in severance expense primarily driven by the departure of our Chief Revenue Officer. The increase in marketing expenses was comprised of a \$0.7 million increase in advertising and lead generation costs offset by decreases in share-based compensation of \$0.2 million and a \$0.1 million reduction of expenses related to outside consulting. The reduction of share-based compensation expenses was the result of a \$0.1 million decrease driven by workforce reductions which occurred during the prior fiscal year, and a \$0.1 million reversal of previously recorded share-based compensation related to consultants.

Engineering and product development expenses. The \$0.2 million increase in engineering and product development costs was primarily driven by an increase in consulting expenses related to outside development services.

General and administrative expenses. The \$0.4 million increase in general and administrative expenses was primarily driven by an increase in outside consulting and professional services expenses related to the contested election of directors at our 2016 annual shareholders meeting in April 2016.

Other income (expense)

	Three Months Ended			
	June 30,		Increase	Percentage
	2016	2015	(Decrease)	Change
Other income	\$ 16	\$ -	\$ 16	100 %
Foreign currency transaction loss	\$ (20)	\$ (36)	\$ (16)	(44)%

Other income (expense). There was a minimal amount of other income for the three months ended June 30, 2016 and 2015.

Foreign currency transactions loss. The foreign currency losses for the three months ended June 30, 2016 and 2015 were primarily attributable to fluctuations of the British pound sterling, Swedish krona and other foreign currencies in which we transact business relative to the U.S. dollar.

Provision (benefit) for income taxes

	Three Months Ended			Percentage
	June 30,	2015	Increase	Change
	2016			
Income tax expense (benefit)	\$ 1,806	\$ (96)	\$ 1,902	(1,981)%

During the three months ended June 30, 2016, the Company recorded a tax expense of \$1.8 million, primarily related to the establishment of a valuation allowance against Swedish tax assets, estimated state taxes, and accruing interest on uncertain tax positions. During the three months ended June 30, 2015, the Company recorded a tax benefit of \$0.1 million, primarily related to the change in the deferred tax asset in Sweden as a result of generating losses, estimated state taxes, return to provision adjustments, and accrued interest and penalties on uncertain tax positions.

Nine Months Ended June 30, 2016 Compared to

Nine Months Ended June 30, 2015

Total Revenues

	Nine			Percentage
	Months Ended		Increase	Change
	June 30,	2015	(Decrease)	
	2016			
Software licenses	\$ 10,461	\$ 11,203	\$ (742)	(7)%
Maintenance	10,417	10,016	401	4
Professional services	977	980	(3)	(0)
Total revenue	\$ 21,855	\$ 22,199	\$ (344)	(2)%

Software license revenue. Software license revenue decreased \$0.7 million when compared with revenue for the nine months ended June 30, 2015. During the second half of fiscal 2015, we implemented a change in our pricing practice for Monarch requiring all new or non-current maintenance customers purchasing fewer than ten seats of Monarch, to purchase term licenses instead of perpetual licenses. The decrease in software license revenue was due to a decrease in perpetual software license revenue of \$2.1 million, caused in part by the pricing change, offset by an increase in subscription license revenue of \$1.4 million compared to the nine months ended June 30, 2015. Since this pricing change went into effect, we have observed the continued growth of our deferred license revenue related to subscription software, which we believe will translate into software license revenue in future quarters. Overall our deferred revenue increased by \$1.6 million as of June 30, 2016 compared to the end of the same quarter last fiscal year. Of the total deferred revenue increase, deferred license revenue increased \$1.2 million, almost 160%, as a direct result of the pricing change.

Maintenance revenue. The \$0.4 million increase in maintenance revenue was the result of increased renewal rates across all product lines compared to the prior fiscal year. Renewal rates during the nine months ended June 30, 2016 increased to 67% from 62% for the nine months ended June 30, 2015. In addition, at June 30, 2016, we noted an increase in maintenance deferred revenue of 6% to \$6.9 million compared to \$6.6 million at for the same period last fiscal year.

Professional services. Professional services revenue remained largely unchanged compared to the last fiscal year.

Total Costs and Expenses

	Nine Months Ended			
	June 30, 2016	2015	Increase (Decrease)	Percentage Change
Cost of software licenses	\$2,067	\$2,293	\$ (226)	(10)%
Cost of maintenance and services	1,707	2,519	(812)	(32)
Sales and marketing	15,621	21,303	(5,682)	(27)
Engineering and product development	6,089	6,698	(609)	(9)
General and administrative	7,453	6,779	674	10
Impairment of goodwill and long-lived assets	-	32,009	(32,009)	(100)
Total costs and operating expenses	\$32,937	\$71,601	\$ (38,664)	(54)%

Cost of software licenses. The \$0.2 million decrease was primarily due to decreased amortization expense of acquired intangibles due to the reduction in carrying value of long-lived assets as a result of the impairment of goodwill and long-lived assets recorded during the nine months ended June 30, 2015.

Cost of maintenance and services. The \$0.8 million decrease was primarily driven by a reduction of employee related costs and restructuring charges. As a result of workforce reductions that occurred during the nine months ended June 30, 2015, employee related expenses, such as salaries, payroll taxes and benefits decreased \$0.6 million for the nine months ended June 30, 2016 when compared to prior fiscal year. In addition, restructuring charges due to the workforce reductions, decreased \$0.3 million for the nine months ended June 30, 2016 when compared to prior fiscal year. The reduction in employee related costs and restructuring charges were offset by a \$0.1 million increase in outside consulting services.

Sales and marketing expenses. The \$5.7 million decrease in sales and marketing expenses was comprised of a decrease in sales expense of \$5.3 million and a decrease in marketing expense of \$0.4 million. The decreased sales expenses were primarily driven by workforce reductions which occurred during the nine months ended June 30, 2015, including a decrease of \$2.5 million in employee related expenses, such as salaries, payroll taxes and benefits, and a \$0.6 million decrease in travel related expenses. Share-based compensation decreased \$1.6 as a result of numerous factors, including a \$1.0 million decrease due to the reduction in headcount, a decrease in expense of \$0.3 million due to the departure of our Chief Revenue Officer and a \$0.3 million decrease in share-based compensation due to the decreased fair value of share-based awards issued to consultants. In addition, to the decreased expenses resulting from the workforce reductions and the decreased share-based compensation, we also realized a \$0.5 million decrease in spending related to outside consultants and a \$0.1 million reduction in amortization expense due to the impairment of goodwill and long-lived assets which occurred during the nine months ended June 30, 2015. These decreases were partially offset by a \$0.1 million increase in severance expense primarily due to the departure of our Chief Revenue Officer. The decreased marketing expenses were primarily driven by workforce reductions which occurred during the

nine months ended June 30, 2015, including a decrease of \$0.5 million in employee related expenses, such as salaries, payroll taxes and benefits, and a \$0.3 million decrease in restructuring charges. In addition, to the decreased expenses resulting from the workforce reductions, we also realized a \$0.3 million decrease in spending related to outside consultants and a \$0.2 million decrease in share-based compensation expenses due to workforce reductions, which occurred during the nine months ended June 30, 2015, and a \$0.1 million decrease in share-based compensation due to the decreased fair value of share-based awards issued to consultants. The decreases in marketing expenses were partially offset by an increase of \$0.9 million in advertising, public relations and lead generation activities

Engineering and product development expenses. The \$0.6 million decrease was driven primarily by workforce reductions which occurred during the nine months ended June 30, 2015, including \$0.6 million decrease in employee related expenses such as salaries, payroll taxes and benefits, a \$0.3 million decrease in restructuring charges and a \$0.1 million decrease in stock-based compensation. The planned decreased headcount was primarily related to resources focused on legacy products, due to the restructuring efforts that occurred during our last fiscal year. The cost reductions related to the decrease in headcount were partially offset by a \$0.4 million increase in consulting expenses related to outside development services.

General and administrative expenses. The \$0.7 million increase was primarily attributable outside consulting and professional services expenses related to the contested election of our directors at our 2016 annual shareholders meeting in April 2016.

Impairment of goodwill and long-lived assets. During the nine months ended June 30, 2015, we recorded goodwill and long-lived assets impairment charges of \$21.7 million and \$10.3 million, respectively, as a result of performing an interim impairment review as required under Accounting Standards Codification (“ASC”) 350 *Intangibles – Goodwill and Other*. We did not record any impairment charges during the nine months ended June 30, 2016.

Other income (expense)

	Nine Months Ended June 30,			Percentage	
	2016	2015	Increase	Change	
Other income	\$ 34	\$ 9	\$ 25	278	%
Foreign currency transaction loss	\$ (53)	\$ (47)	\$ 6	13	%

Other income (expense). There was a minimal amount of other income for the nine months ended June 30, 2016 and 2015.

Foreign currency transactions loss. The foreign currency loss for the nine months ended June 30, 2016 and 2015 were primarily attributable to fluctuations of the British pound sterling and other foreign currencies in which we transact business related to the U.S. dollar.

Provision (benefit) for income taxes

	Nine Months Ended June 30,			Percentage	
	2016	2015	Increase	Change	
Income tax expense (benefit)	\$ 1,599	\$ (2,632)	\$ 4,231	(161)%

The increase in income tax expense was primarily due to the change in the valuation allowance against Swedish tax assets which occurred in the quarter ended June 30, 2016. For the nine months ended June 30, 2015, we recorded a tax benefit of \$2.6 million, due to a change in the deferred tax liability in Sweden as a result of impairing non-goodwill intangibles and amortization.

OFF BALANCE SHEET ARRANGEMENTS, CONTRACTUAL OBLIGATIONS AND CONTINGENT LIABILITIES AND COMMITMENTS

We lease various facilities and equipment in the U.S. and overseas under non-cancelable operating leases which expire at various dates through 2022. The lease agreements generally provide for the payment of minimum annual rentals and pro-rata share of taxes and maintenance expenses. Rental expense for all operating leases was \$0.3 million for both the three months ended June 30, 2016 and 2015, and was \$0.8 million for both the nine months ended June 30, 2016 and 2015. Certain of our facility leases include options to renew.

On June 23, 2015, we entered into a facility lease in Bedford, MA for a new corporate headquarters. The lease is for 20,360 square feet and has a term of 84 months which commenced in January 2016 when we moved in. Our monthly rent expense is \$42,000. In conjunction with entering into the lease, we were required to deposit \$0.2 million into a restricted cash account as collateral for a Letter of Credit, which is included under the caption "Other long-term assets" in our consolidated balance sheets, at June 30, 2016. Deferred rent of \$0.2 million is included under the caption "Other long-term liabilities" in our consolidated balance sheets, at June 30, 2016. There was no deferred rent at September 30, 2015.

As of June 30, 2016, our contractual obligations include minimum rental commitments under non-cancelable operating leases and other long-term liabilities related to uncertain tax positions as follows (in thousands):

		Less than			More than
Contractual Obligations:	Total	1 Year	1 – 2 Years	3 – 5 Years	5 Years
Operating lease obligations	\$4,131	\$179	\$1,456	\$1,187	\$1,309
Other long-term liabilities	\$522	\$-	\$-	\$-	\$522

Royalty expense included in cost of software licenses was \$0.3 million and \$0.2 million for the three months ended June 30, 2016 and 2015, respectively, and \$0.4 million for both the nine months ended June 30, 2016 and 2015.

Our software products are sold under warranty against certain defects in material and workmanship for a period of 30 to 90 days from the date of purchase. If necessary, we would provide for the estimated cost of warranties based on specific warranty claims and claim history. However, we have never incurred significant expense under our product or service warranties. As a result, we believe our exposure related to these warranty agreements is minimal. Accordingly, we have no liabilities recorded for warranty claims as of June 30, 2016 and September 30, 2015.

We enter into indemnification agreements in the ordinary course of business. Pursuant to these agreements, we generally agree to indemnify, hold harmless, and reimburse the indemnified party for losses suffered or incurred by the indemnified party, generally our customers, in connection with any patent, copyright or other intellectual property infringement claim by any third party with respect to our products. The term of these indemnification agreements is generally perpetual. The maximum potential amount of future payments we could be required to make under these indemnification agreements is unlimited. We have never incurred costs to defend lawsuits or settle claims related to these indemnification agreements. As a result, we believe our exposure related to these agreements is minimal. Accordingly, we have no liabilities recorded for these potential obligations as of June 30, 2016 and September 30, 2015.

Certain of our agreements also provide for the performance of services at customer sites. These agreements may contain indemnification clauses, whereby we will indemnify the customer from any and all damages, losses, judgments, costs and expenses for acts of our employees or subcontractors resulting in bodily injury or property damage. The maximum potential amount of future payments we could be required to make under these indemnification agreements is unlimited; however, we have general and umbrella insurance policies that would enable us to recover a portion of any amounts paid. We have never incurred costs to defend lawsuits or settle claims related to these indemnification agreements. As a result, we believe our exposure related to these agreements is minimal. Accordingly, we have no liabilities recorded for these potential obligations as of June 30, 2016 and September 30, 2015.

As permitted under Delaware law, we have agreements with our directors whereby we will indemnify them for certain events or occurrences while the director is, or was, serving at our request in such capacity. The term of the director indemnification period is for the later of ten years after the date that the director ceases to serve in such capacity or the final termination of proceedings against the director as outlined in the indemnification agreement. The maximum potential amount of future payments we could be required to make under these indemnification agreements is unlimited; however, our director and officer insurance policy would enable us to recover a portion of any future amounts paid. As a result of our insurance policy coverage, we believe our exposure related to these indemnification agreements is minimal. Accordingly, we have no liabilities recorded for these potential obligations as of June 30, 2016 and September 30, 2015.

LIQUIDITY AND CAPITAL RESOURCES

We believe that our current cash balances will be sufficient to meet our cash needs for working capital and anticipated capital expenditures for at least the next twelve months. At June 30, 2016, we had \$28.8 million of cash and cash equivalents as compared \$35.2 million as of September 30, 2015, a decrease of \$6.4 million. \$1.2 million of cash and cash equivalents at June 30, 2016 was located in foreign banks.

At June 30, 2016, we had working capital of \$24.1 million as compared to \$31.3 million as of September 30, 2015. We do not anticipate additional cash requirements to fund growth or the acquisition of additional complementary technology or businesses. However, if in the future, such expenditures are anticipated or required, we may seek additional financing by issuing equity or obtaining credit facilities to fund such requirements. There can be no assurance that we will be able to issue additional equity or obtain a new or expanded credit facility at attractive prices or rates, or at all.

We had a net loss of \$12.7 million for the nine months ended June 30, 2016 as compared to net loss of \$46.8 million for the nine months ended June 30, 2015. During the nine months ended June 30, 2016 and 2015, \$5.5 million and \$10.9 million of cash was used in our operations, respectively. During the nine months ended June 30, 2016, the main use of cash in operations was net loss adjusted for depreciation and amortization, share-based compensation expense, deferred income taxes, as well as the decrease in accounts receivable and the increase in deferred revenue offset by the decreases in accounts payable, accrued expenses and other liabilities. During the nine months ended June 30, 2015, the main use of cash in operations was net loss adjusted for depreciation and amortization, share-based compensation expense, deferred income taxes and the impairment of goodwill and long-lived assets as well as the increases in accounts receivable and accounts payable offset by decreases in prepaid expenses and other assets and deferred revenue.

Net cash used in investing activities of \$0.9 million and \$0.4 million for the nine months ended June 30, 2016 and 2015, respectively, was related to the purchase of property and equipment.

Net cash provided by financing activities of \$0.1 million for both the nine months ended June 30, 2016 and 2015, was related to the proceeds from the issuance of common stock upon the exercise of outstanding stock option awards.

We believe that our current operations have not been materially impacted by the effects of inflation.

Item 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Derivative Financial Instruments, Other Financial Instruments, and Derivative Commodity Instruments

At June 30, 2016, we did not participate in or hold any derivative financial instruments or commodity instruments. We hold no investment securities that possess significant market risk.

Primary Market Risk Exposures

Our primary market risk exposure is foreign currency exchange rate risk. International revenues and expenses are generally transacted by our foreign subsidiaries and are denominated in local currency. 16% and 20% of our revenues for the three months ended June 30, 2016 and 2015, respectively, and 14% and 21% of our revenues for the nine months ended June 30, 2016 and 2015, respectively, were from our foreign subsidiaries. In addition, 19% and 25% of our operating expenses for the three months ended June 30, 2016 and 2015, respectively, and 18% and 14% of our operating expenses for the nine months ended June 30, 2016 and 2015, respectively, were from our foreign subsidiaries.

We are exposed to foreign currency exchange rate risk inherent in conducting business globally in several currencies, of which the most significant to our operations has historically been the British Pound. Our exposure to currency exchange rate fluctuations has been and is expected to continue to be modest due to the fact that the operations of our international subsidiaries are almost exclusively conducted in their respective local currencies, and dollar advances to our international subsidiaries, if any, are usually considered to be of a long-term investment nature. Accordingly, the majority of currency movements are reflected in our other comprehensive (loss) income. Foreign currency translation gains arising during the three and nine months ended June 30, 2016 were \$44,000 and \$0.1 million, respectively. Foreign currency translation gains arising during the three months ended June 30, 2015 were \$0.1 million. Foreign currency translation losses arising during the nine months ended June 30, 2015 were \$29,000. There are, however, certain situations where we will invoice customers in currencies other than our own. Such gains or losses from operating activity, whether realized or unrealized, are reflected in “Foreign currency transaction gain (loss)” section of the accompanying consolidated statements of operations and were losses from foreign currency transactions of \$20,000 and \$36,000 for the three months ended June 30, 2016 and 2015, respectively, and \$0.1 million and \$47,000 for the nine months ended June 30, 2016 and 2015, respectively.

Item 4. CONTROLS AND PROCEDURES

Our management, including the principal executive officer and principal financial officer, have evaluated our disclosure controls and procedures as of the end of the period covered by this report and have concluded that our disclosure controls and procedures are effective. They also concluded that there were no changes in our internal control over financial reporting, which have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting as of the end of the period covered by this report.

PART II. OTHER INFORMATION

Item 1. LEGAL PROCEEDINGS

We are occasionally involved in legal proceedings and other claims arising out of our operations in the normal course of business. We are not party to any litigation that we believe will have a material adverse effect on our consolidated financial condition, results of operations or cash flows.

Item 1A. RISK FACTORS

In addition to the other information set forth in this report, the reader should carefully consider the factors discussed in Part I, Item 1A under the heading “Risk Factors” in our Annual Report on Form 10-K for the year ended September 30, 2015, which could materially affect our business, financial condition or future results. The risks described in our Annual Report on Form 10-K are not the only risks facing the Company. Additional risks and uncertainties not currently known or that it currently deems to be immaterial also may materially adversely affect our business, financial condition and/or operating results.

Risks Relating to Our Business

Actions of activist stockholders against us could be disruptive and potentially costly and the possibility that activist stockholders may seek changes that contest, or conflict with, our strategic direction could cause uncertainty about the strategic direction of our business.

Activist stockholders may from time to time attempt to effect changes in our strategic direction and, in furtherance thereof, may seek changes in how the Company is governed. While our Board of Directors and management team strive to maintain constructive, ongoing communications with all of the Company’s stockholders, including activist stockholders, and welcome their views and opinions with the goal of working together constructively to enhance value for all stockholders, activist campaigns that contest, or conflict with, our strategic direction could have an adverse effect on our business because:

Responding to proxy contests and other actions by activist stockholders can disrupt our operations, be costly and time-consuming, and divert the attention of our Board of Directors and senior management from the pursuit of business strategies, which could adversely affect our results of operations and financial condition; Perceived uncertainties as to our future direction as a result of changes to the composition of our Board of Directors may lead to the perception of a change in the direction of the business, instability or lack of continuity which may be exploited by our competitors, cause concern to our current or potential customers, may result in the loss of potential business opportunities and make it more difficult to attract and retain qualified personnel and business partners; These types of actions could cause significant fluctuations in our stock price based on temporary or speculative market perceptions or other factors that do not necessarily reflect the underlying fundamentals and prospects of our business; and

If individuals are elected to our Board of Directors with a specific agenda, it may adversely affect our ability to effectively implement our business strategy and create additional value for our stockholders.

Item 4. MINE SAFETY DISCLOSURES

Not applicable.

Item 6. Exhibits

- 31.1 Certification of the Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 31.2 Certification of the Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 32.1 Certification of the Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- 32.2 Certification of the Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- 101 The following materials from the Company's Quarterly Report on Form 10-Q for the quarter ended June 30, 2016 formatted in Extensible Business Reporting Language (XBRL).

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized on July 25, 2016.

DATAWATCH CORPORATION

/s/ Michael A. Morrison
Michael A. Morrison
President, Chief Executive Officer, and
Director (Principal Executive Officer)

/s/ James L. Eliason
James L. Eliason
Chief Financial Officer
(Principal Financial Officer)