

AGILYSYS INC
Form 10-Q
February 09, 2016
Table of Contents

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

FORM 10-Q

(Mark One)

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

For the quarterly period ended December 31, 2015

or

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

For the transition period from _____ to _____.

Commission file number 0-5734

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

Ohio	34-0907152
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

425 Walnut Street, Suite 1800, Cincinnati, Ohio	45202
(Address of principal executive offices)	(ZIP Code)

(770) 810-7800
(Registrant's telephone number, including area code)

N/A
(Former name, former address and former fiscal year, if changed since last report)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes ☒ No ☐

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

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Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of “large accelerated filer,” “accelerated filer,” and “smaller reporting company” in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer ☐ Accelerated filer ☒ x

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

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

The number of Common Shares of the registrant outstanding as of January 29, 2016 was 22,974,056.

Table of Contents

AGILYSYS, INC.

Index

Part I. Financial Information

Item 1	Financial Statements	<u>3</u>
	Condensed Consolidated Balance Sheets (Unaudited) - December 31, 2015 and March 31, 2015	<u>3</u>
	Condensed Consolidated Statements of Operations (Unaudited) - Three and Nine Months Ended December 31, 2015 and December 31, 2014	<u>4</u>
	Condensed Consolidated Statements of Comprehensive Loss (Unaudited) - Three and Nine Months Ended December 31, 2015 and December 31, 2014	<u>5</u>
	Condensed Consolidated Statements of Cash Flows (Unaudited) - Nine Months Ended December 31, 2015 and December 31, 2014	<u>6</u>
Item 2	Notes to Condensed Consolidated Financial Statements (Unaudited) Management's Discussion and Analysis of Financial Condition and Results of Operations	<u>7</u> <u>19</u>
Item 3	Quantitative and Qualitative Disclosures About Market Risk	<u>31</u>
Item 4	Controls and Procedures	<u>31</u>

Part II. Other Information

Item 1	Legal Proceedings	<u>32</u>
Item 1A	Risk Factors	<u>32</u>
Item 2	Unregistered Sales of Equity Securities and Use of Proceeds	<u>33</u>
Item 3	Defaults Upon Senior Securities	<u>33</u>
Item 4	Mine Safety Disclosures	<u>33</u>
Item 5	Other Information	<u>33</u>
Item 6	Exhibits	<u>33</u>

Signatures

Table of Contents

AGILYSYS, INC.
 CONDENSED CONSOLIDATED BALANCE SHEETS
 (Unaudited)

	December 31, 2015	March 31, 2015
(In thousands, except share data)		
ASSETS		
Current assets:		
Cash and cash equivalents	\$65,652	\$75,067
Accounts receivable, net of allowance for doubtful accounts of \$628 and \$888, respectively	20,907	25,481
Inventories	2,331	641
Prepaid expenses and other current assets	6,587	3,828
Total current assets	95,477	105,017
Property and equipment, net	13,857	11,929
Goodwill	19,622	19,622
Intangible assets, net	8,880	9,006
Software development costs, net	41,371	31,818
Other non-current assets	4,670	4,133
Total assets	\$183,877	\$181,525
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	\$11,402	\$16,586
Deferred revenue	29,371	23,881
Accrued liabilities	11,107	10,001
Capital lease obligations, current	136	142
Total current liabilities	52,016	50,610
Deferred income taxes, non-current	3,049	3,053
Capital lease obligations, non-current	25	47
Other non-current liabilities	4,563	3,627
Commitments and contingencies (see Note 8)		
Shareholders' equity:		
Common shares, without par value, at \$0.30 stated value; 80,000,000 shares authorized; 31,606,831 shares issued; and 22,949,056 and 22,789,355 shares outstanding at December 31, 2015 and March 31, 2015, respectively	9,482	9,482
Treasury shares, 8,657,775 and 8,817,477 at December 31, 2015 and March 31, 2015, respectively	(2,598)	(2,646)
Capital in excess of stated value	(8,433)	(10,675)
Retained earnings	125,951	128,178
Accumulated other comprehensive loss	(178)	(151)
Total shareholders' equity	124,224	124,188
Total liabilities and shareholders' equity	\$183,877	\$181,525

See accompanying notes to condensed consolidated financial statements.

Table of Contents

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

	Three months ended December 31,		Nine months ended December 31,			
(In thousands, except share data)	2015	2014	2015	2014		
Net revenue:						
Products	\$11,924	\$7,247	\$30,678	\$20,948		
Support, maintenance and subscription services	14,896	13,920	44,460	41,514		
Professional services	4,487	3,575	13,304	12,344		
Total net revenue	31,307	24,742	88,442	74,806		
Cost of goods sold:						
Products	6,991	4,413	17,035	11,414		
Support, maintenance and subscription services	4,076	3,006	11,413	9,098		
Professional services	3,732	3,194	9,496	8,823		
Total cost of goods sold	14,799	10,613	37,944	29,335		
Gross profit	16,508	14,129	50,498	45,471		
	52.7	% 57.1	% 57.1	% 60.8		%
Operating expenses:						
Product development	6,969	6,670	20,021	18,726		
Sales and marketing	4,618	3,696	14,396	11,407		
General and administrative	5,517	5,175	15,897	16,369		
Depreciation of fixed assets	569	556	1,627	1,702		
Amortization of intangibles	321	617	937	2,994		
Restructuring, severance and other charges	8	95	(53)	) 913		
Asset write-offs and other fair value adjustments	—	—	(175)	) —		
Legal settlements	185	—	185	203		
Operating loss	(1,679)	) (2,680)	) (2,337)	) (6,843)	)	
Other (income) expense:						
Interest income	(21)	) (24)	) (70)	) (98)	)	
Interest expense	8	7	20	35		
Other expense, net	63	114	40	68		
Loss before taxes	(1,729)	) (2,777)	) (2,327)	) (6,848)	)	
Income tax benefit	(56)	) (62)	) (100)	) (777)	)	
Net loss	\$(1,673)	) \$(2,715)	) \$(2,227)	) \$(6,071)	)	
Weighted average shares outstanding	22,493	22,343	22,479	22,336		
Loss per share - basic and diluted:						
Loss per share	\$(0.07)	) \$(0.12)	) \$(0.10)	) \$(0.27)	)	

See accompanying notes to condensed consolidated financial statements.

Table of Contents

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

(In thousands)	Three months ended December 31,		Nine months ended December 31,	
	2015	2014	2015	2014
Net loss	\$(1,673	) \$(2,715	) \$(2,227	) \$(6,071
Other comprehensive loss, net of tax:				
Unrealized foreign currency translation adjustments	(8	) (8	) (27	) (12
Unrealized loss on sale of securities	—	1	—	(4
Total comprehensive loss	\$(1,681	) \$(2,722	) \$(2,254	) \$(6,087

See accompanying notes to condensed consolidated financial statements.

Table of Contents

AGILYSYS, INC.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)

	Nine months ended December 31,	
(In thousands)	2015	2014
Operating activities		
Net loss	\$ (2,227)	\$ (6,071)
Adjustments to reconcile loss from operations to net cash provided by (used in) operating activities		
Net restructuring, severance and other charges	(643)	(276)
Asset write-offs and other fair value adjustments	(175)	—
Net legal settlements	170	(1,511)
Loss on disposal of property & equipment	262	1
Depreciation	1,627	1,702
Amortization	1,704	3,939
Deferred income taxes	—	(86)
Share-based compensation	2,318	1,828
Excess tax benefit from equity awards	—	(14)
Changes in operating assets and liabilities:		
Accounts receivable	4,527	2,342
Inventories	(1,696)	(170)
Prepaid expense	(2,769)	325
Accounts payable	(4,399)	(55)
Deferred revenue	5,516	(4,535)
Accrued liabilities	4,394	(3,841)
Income taxes payable	(65)	(817)
Other changes, net	(230)	(230)
Net cash provided by (used in) operating activities	8,314	(7,469)
Investing activities		
Proceeds from sale of business units	—	809
Cash paid for acquisition, net	—	(3,750)
Proceeds from sale and maturity of marketable securities	—	5,107
Investments in marketable securities	—	(10,240)
Capital expenditures	(3,617)	(3,856)
Capitalized software development costs	(13,488)	(12,540)
Additional (investments in) proceeds from corporate-owned life insurance policies	(65)	1,925
Net cash used in investing activities	(17,170)	(22,545)
Financing activities		
Repurchase of common shares to satisfy employee tax withholding	(435)	(373)
Exercise of employee stock options	—	102
Excess tax benefit from equity awards	—	14
Principal payments under long-term obligations	(29)	(32)
Net cash used in financing activities	(464)	(289)
Effect of exchange rate changes on cash	(95)	(154)
Net decrease in cash and cash equivalents	(9,415)	(30,457)
Cash and cash equivalents at beginning of period	\$ 75,067	\$ 99,566
Cash and cash equivalents at end of period	\$ 65,652	\$ 69,109

SUPPLEMENTAL SCHEDULE OF NON-CASH INVESTING ACTIVITIES:

Accrued capital expenditures	\$261	\$353
Accrued capitalized software development costs	505	2,021
Leasehold improvements acquired under lease arrangement	997	—

See accompanying notes to condensed consolidated financial statements.

Table of Contents

AGILYSYS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

(Table amounts in thousands, except per share data)

1. Nature of Operations and Financial Statement Presentation

Nature of Operations

Agilysys is a leading technology company that provides innovative software for point-of-sale (POS), property management, inventory and procurement, workforce management, analytics, document management and mobile and wireless solutions and services to the hospitality industry. Our solutions and services allow property managers to better connect, interact and transact with their customers and enhance their customer relationships by streamlining operations, improving efficiency, increasing guest recruitment and wallet share, and enhancing the overall guest experience. We serve four major market sectors: Gaming, both corporate and tribal; Hotels, Resorts and Cruise; Foodservice Management; and Restaurants, Universities, Stadia and Healthcare. A significant portion of our consolidated revenue is derived from contract support, maintenance and subscription services.

We operate throughout North America, Europe and Asia, with corporate services located in Alpharetta, GA, and offices in Singapore, Hong Kong and Malaysia.

Basis of Presentation

The accompanying unaudited Condensed Consolidated Financial Statements include our accounts consolidated with our wholly-owned subsidiaries. All significant intercompany accounts and transactions have been eliminated in consolidation. Our fiscal year ends on March 31st. References to a particular year refer to the fiscal year ending in March of that year. For example, fiscal 2016 refers to the fiscal year ending March 31, 2016.

Our unaudited interim financial statements are prepared in accordance with U.S. generally accepted accounting principles (GAAP) for interim financial information, the instructions to the Quarterly Report on Form 10-Q (Quarterly Report) under the Securities Exchange Act of 1934, as amended (the Exchange Act), and Rule 10-01 of Regulation S-X under the Exchange Act. Certain information and footnote disclosures normally included in the annual financial statements prepared in accordance with GAAP have been condensed or omitted pursuant to such rules and regulations relating to interim financial statements.

The Condensed Consolidated Balance Sheet as of December 31, 2015, as well as the Condensed Consolidated Statements of Operations, Condensed Consolidated Statements of Comprehensive Loss, and the Condensed Consolidated Statements of Cash Flow for the three and nine months ended December 31, 2015 and 2014, are unaudited. However, these financial statements have been prepared on the same basis as those in the audited annual financial statements. In the opinion of management, all adjustments of a recurring nature necessary to fairly state the results of operations, financial position, and cash flows have been made.

These unaudited interim financial statements should be read together with the consolidated financial statements and related notes included in our Annual Report on Form 10-K for the year ended March 31, 2015, filed with the Securities and Exchange Commission (SEC) on June 5, 2015.

Correction of Errors

In connection with the preparation of our Condensed Consolidated Financial Statements for the second quarter of fiscal 2016, we identified errors in the manner in which we recognized revenue on contract support. Contract support

revenue is recognized ratably over the term of the customer arrangement. In certain instances where contract support is an element of a multiple-element arrangement, we use a hierarchy to determine the fair value allocation for recognition of revenue on each deliverable. An error related to an input used in this allocation resulted in the overstatement of contract, maintenance, and support revenue of \$0.4 million for the three months ended June 30, 2015. The error was identified and

corrected during the second quarter of fiscal 2016. Additionally, during the second quarter of fiscal 2016, we identified errors in the manner in which we capitalize internal labor on software development projects. An error in the method by which internal resources account for administrative time resulted in the over capitalization of costs during the last six months of fiscal 2015 and the first three months of fiscal 2016. The error for each of the three months ended December 31, 2014, March 31, 2015, and June 30, 2015, was \$0.1 million. We corrected these errors during the second quarter of fiscal 2016.

In accordance with accounting guidance found in ASC 250-10 (SEC Staff Accounting Bulletin No. 99, Materiality), we assessed the materiality of the errors and concluded that the errors were not material to any of our previously issued financial statements. Correction of the errors is also not material to the nine month period ended December 31, 2015 or to our estimated fiscal 2016 results.

2. Summary of Significant Accounting Policies

A detailed description of our significant accounting policies can be found in the audited financial statements for the fiscal year ended March 31, 2015, included in our Annual Report on Form 10-K. There have been no material changes to our significant accounting policies and estimates from those disclosed therein.

Adopted and Recently Issued Accounting Pronouncements

In June 2015, Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2015-10, Technical Corrections and Updates. The amendments in this update cover a wide range of topics in the codification and are generally categorized as follows: Amendments Related to Differences between Original Guidance and the Codification; Guidance Clarification and Reference Corrections; Simplification; and, Minor Improvements. The amendments are effective for fiscal years and interim periods within those fiscal years, beginning after December 15, 2015. Early adoption is permitted, but not required; and at this time we are not early adopting. As the objectives of this standard are to clarify the codification; correct unintended application of guidance; eliminate inconsistencies; and, to improve the codification's presentation of guidance, the adoption of this standard is not expected to have a material impact on our financial position or results of operations.

In May 2014, the FASB issued Accounting Standards Update (ASU) No. 2014-09, Revenue from Contracts with Customers, which converges the FASB and the International Accounting Standards Board standard on revenue recognition. Areas of revenue recognition that will be affected include, but are not limited to, transfer of control, variable consideration, allocation of transfer pricing, licenses, time value of money, contract costs and disclosures. In August 2015, the FASB amended the effective date and early adoption is permitted only for fiscal years beginning after December 15, 2016. We are currently evaluating the impact that the adoption of ASU 2014-09 will have on our consolidated financial statements or related disclosures.

In November 2015, the FASB issued ASU No. 2015-17, Balance Sheet Classification of Deferred Taxes, which eliminates the current requirement to present deferred tax assets and liabilities as current and noncurrent in a classified balance sheet. Instead, entities will be required to classify all deferred tax assets and liabilities as noncurrent. The guidance is effective for annual periods, and interim periods within those annual periods, beginning after December 15, 2016, with early adoption permitted. We have evaluated the effect this pronouncement will have on our consolidated financial statements and related disclosures and determined the adoption of this standard is not expected to be material based on current classification of deferred tax assets and liabilities. We plan to early adopt for the period ending March 31, 2016.

Management continually evaluates the potential impact, if any, of all recent accounting pronouncements on our consolidated financial statements or related disclosures and, if significant, makes the appropriate disclosures required by such new accounting pronouncements.

Table of Contents

3. Acquisitions

Purchase of assets from Dining Ventures - Fiscal 2015

On July 3, 2014, Agilysys purchased certain assets from Dining Ventures, Inc. The acquired assets are the base for our rGuest® Seat product, a dining reservations and table management application. The purchase consideration consisted of approximately \$3.8 million and was funded with cash on hand. Management concluded that this acquisition was not a material acquisition under the provisions of ASC 805, Business Combinations (ASC 805). The results derived from this purchased asset have been included in our Consolidated Financial Statements from the date of acquisition and did not have a material impact on our condensed consolidated financial statements or related disclosures.

The following is a summary of the fair values of the assets acquired in the acquisition:

(In thousands)

Goodwill	\$2,464
Developed technology	1,286
Total assets acquired	\$3,750

The goodwill of approximately \$2.5 million arising from the acquisition consists largely of synergies expected from combining the developed technology of Dining Ventures with Agilysys' operations. The goodwill from this acquisition is deductible for tax purposes over a period of 15 years.

The following is a summary of the intangible asset acquired and the weighted-average useful life over which it will be amortized.

	Purchased assets	Weighted-average useful life
Developed technology	\$1,286	5 years

The developed technology acquired from Dining Ventures was determined to be an internal use asset and is therefore carried in fixed assets on the balance sheet and amortized in operating expenses.

Table of Contents

4. Restructuring Charges

We recognize restructuring charges when a plan that materially changes the scope of our business or the manner in which that business is conducted is adopted and communicated to the impacted parties, and the expenses have been incurred or are reasonably estimable.

Fiscal 2015 Restructuring Activity

Q2 - In the second quarter of fiscal 2015, we implemented restructuring actions to better align product development, sales and marketing and general and administrative functions with our company strategy and to reduce operating costs. To date, we have recorded \$0.2 million in restructuring charges related to the Q2 fiscal 2015 restructuring activity, comprised of severance and other employee related benefits.

Q4 - In the fourth quarter of fiscal 2015, we announced additional restructuring actions designed to continue the effort to better align product development, sales and marketing and general and administrative functions with our company strategy and to reduce operating costs. To date, we have recorded \$0.4 million in restructuring charges related to the Q4 fiscal 2015 restructuring activity, comprised of severance and other employee related benefits.

As of December 31, 2015, there was no further liability for any of the fiscal 2015 restructuring activities.

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

(In thousands)	Balance at March 31, 2015	Provision / Adjustments	Payments	Balance at December 31, 2015
Fiscal 2015 Restructuring Plan:				
Severance and other employment costs	\$450	\$(73)	\$(377)	\$—
Total restructuring costs	\$450	\$(73)	\$(377)	\$—

Table of Contents

5. Intangible Assets and Software Development Costs

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

(In thousands)	December 31, 2015			March 31, 2015		
	Gross carrying amount	Accumulated amortization	Net carrying amount	Gross carrying amount	Accumulated amortization	Net carrying amount
Amortized intangible assets:						
Customer relationships	\$10,775	\$(10,775)	)\$—	\$10,775	\$(10,775)	)\$—
Non-competition agreements	2,700	(2,700)	)—	2,700	(2,700)	)—
Developed technology	10,660	(10,369)	)291	10,660	(10,277)	)383
Trade names	230	(41)	)189	230	(7)	)223
Patented technology	80	(80)	)—	80	(80)	)—
	24,445	(23,965)	)480	24,445	(23,839)	)606
Unamortized intangible assets:						
Trade names	9,200	N/A	9,200	9,200	N/A	9,200
Accumulated impairment	(570)	) N/A	(570)	) (570)	) N/A	(570)
Finite life reclassification	(230)	) N/A	(230)	) (230)	) N/A	(230)
	8,400	N/A	8,400	8,400	N/A	8,400
Total intangible assets	\$32,845	\$(23,965)	)\$8,880	\$32,845	\$(23,839)	)\$9,006
Software development costs	\$6,359	\$(2,119)	)\$4,240	\$6,359	\$(1,443)	)\$4,916
Project expenditures not yet in use	38,522	—	38,522	28,293	—	28,293
Accumulated impairment	(1,391)	) N/A	(1,391)	) (1,391)	) N/A	(1,391)
Total software development costs	\$43,490	\$(2,119)	)\$41,371	\$33,261	\$(1,443)	)\$31,818

The following table summarizes our remaining estimated amortization expense relating to in service intangible assets and software development costs.

(In thousands)	Estimated Amortization Expense
Fiscal year ending March 31,	
2016	\$266
2017	1,067
2018	1,067
2019	844
2020	85
2021	—
Total	\$3,329

Intangible assets are comprised of acquired and internally developed technology to be sold, leased, or otherwise marketed and other non-software assets including, customer relationships, non-competition agreements, trade names and patented technology. Amortization expense of acquired and internally developed technology is included in Products cost of goods sold and was \$0.3 million for the three months ended December 31, 2015 and 2014, and \$0.8 million and \$0.9 million for the nine months ended December 31, 2015 and 2014. Amortization expense of non-software intangibles is included in operating expenses along with acquired and internally developed internal use software. Internal use software is classified as property and equipment in the Consolidated Balance Sheet. Amortization expense of non-software intangible and internal use assets was \$0.3 million and \$0.6 million for the three months ended December 31, 2015 and 2014, and \$0.9 million and \$3.0 million for the nine months ended

December 31, 2015 and 2014.

11

Table of Contents

Capitalized software development costs that are internally developed to be sold, leased, or otherwise marketed, are carried on our balance sheet at net realizable value, net of accumulated amortization. We capitalized approximately \$3.2 million and \$4.3 million during the three months ended December 31, 2015 and 2014, respectively, and \$10.3 million and \$12.1 million during the nine months ended December 31, 2015 and 2014.

6. Additional Balance Sheet Information

Additional information related to the Condensed Consolidated Balance Sheets is as follows:

(In thousands)	December 31, 2015	March 31, 2015
Accrued liabilities:		
Salaries, wages, and related benefits	\$8,205	\$6,768
Other taxes payable	955	952
Accrued legal settlements	230	70
Restructuring liabilities	—	450
Severance liabilities	6	199
Professional fees	656	504
Deferred rent	413	279
Contingent consideration	43	8
Other	599	771
Total	\$11,107	\$10,001
Other non-current liabilities:		
Uncertain tax positions	\$1,459	\$1,499
Deferred rent	2,850	1,666
Contingent consideration	61	104
Other	193	358
Total	\$4,563	\$3,627

Deferred Rent

Deferred rent, current plus non-current, was \$3.3 million and \$1.9 million as of December 31, 2015 and March 31, 2015. During the first nine months of fiscal 2016, the company renewed our operating lease commitments at our Nevada and Washington facilities through fiscal 2022 and fiscal 2024, respectively.

Accounts Receivable, net

Accounts receivable, net of allowance for doubtful accounts was \$20.9 million and \$25.5 million as of December 31, 2015 and March 31, 2015, respectively. The related allowance for doubtful accounts was \$0.6 million and \$0.9 million as of December 31, 2015 and March 31, 2015, respectively.

On January 12, 2015, an involuntary bankruptcy petition was filed against Caesars Entertainment Operating Company, Inc. (Caesars) under Chapter 11 of the U.S. Bankruptcy Code. On January 15, 2015, Caesars and certain of its affiliates filed a voluntary bankruptcy petition under Chapter 11. Those cases have been consolidated in the United States Bankruptcy Court for the Northern District of Illinois. At March 31, 2015, our accounts receivable owing by Caesars and its affiliates who have filed a bankruptcy petition totaled approximately \$3.2 million, including both pre- and post-petition claims. The total amount owed as of March 31, 2015 represents approximately 13% of our outstanding accounts receivable as of March 31, 2015. As of May 26, 2015, we filed a proof of claim with the Bankruptcy Court identifying approximately \$0.7 million of pre-petition claims. In January 2016, we filed an amended proof of claim with the Bankruptcy Court identifying approximately \$0.2 million of pre-petition claim in

addition to those filed on May 26, 2015. As of December 31, 2015, approximately \$0.7 million of pre-petition claims remain outstanding.

7. Income Taxes

The following table compares our income tax benefit and effective tax rates for the three and nine months ended December 31, 2015 and 2014:

(Dollars in thousands)	Three months ended December 31,		Nine months ended December 31,	
	2015	2014	2015	2014
Income tax benefit	\$(56)	\$(62)	\$(100)	\$(777)
Effective tax rate	3.2 %	2.3 %	4.3 %	11.4 %

For the three and nine months ended December 31, 2015, the effective tax rate was different than the statutory rate due primarily to the recognition of net operating losses as deferred tax assets, which were offset by increases in the valuation allowance, an adjustment to true-up indefinite-lived intangibles, a refunded settlement of an unrecognized tax benefit, foreign and state taxes, and other U.S. permanent book to tax differences.

For the three and nine months ended December 31, 2014, the effective tax rate was different than the statutory rate due primarily to the decrease in unrecognized tax benefits attributable to the expiration of statute of limitations, recognition of net operating losses as deferred tax assets, which were offset by increases in the valuation allowance, and other U.S. permanent book to tax differences.

We have recorded a valuation allowance offsetting substantially all of our deferred tax assets. The ultimate realization of deferred tax assets depends on the generation of future taxable income during the periods in which those temporary differences are deductible. Because of our losses in prior periods, management believes that it is more-likely-than-not that we will not realize the benefits of these deductible differences. The amount of valuation allowance, however, could be reduced in the near term. The exact timing will be based on the level of profitability we achieve. We expect a full release of the valuation allowance associated with deferred tax assets in Hong Kong. We expect that the release of the valuation allowance will be recorded as an income tax benefit at the time of release increasing our reported net income. Our recorded tax rate may increase in subsequent periods following a valuation allowance release. Any valuation allowance release will not affect the amount of cash paid for income taxes.

8. Commitments and Contingencies

Agilysys is the subject of various threatened or pending legal actions and contingencies in the normal course of conducting its business. We provide for costs related to these matters when a loss is probable and the amount can be reasonably estimated. The effect of the outcome of these matters on our future results of operations and liquidity cannot be predicted because any such effect depends on future results of operations and the amount or timing of the resolution of such matters. While it is not possible to predict with certainty, management believes that the ultimate resolution of such individual or aggregated matters will not have a material adverse effect on our consolidated financial position, results of operations, or cash flows.

On April 6, 2012, Ameranth, Inc. filed a complaint against us for patent infringement in the United States District Court for the Southern District of California. The complaint alleges, among other things, that point-of-sale and property management and other hospitality information technology products, software, components and/or systems sold by us infringe three patents owned by Ameranth purporting to cover generation and synchronization of menus, including restaurant menus, event tickets, and other products across fixed, wireless and/or internet platforms as well as synchronization of hospitality information and hospitality software applications across fixed, wireless and internet platforms. The complaint seeks monetary damages, injunctive relief, costs and attorneys' fees. At this time, we are not able to predict the outcome of this lawsuit, or any possible monetary exposure associated with the lawsuit. However,

we dispute the allegations of wrongdoing and are vigorously defending ourselves in this matter. The litigation is currently stayed pending appeals of covered business method reviews by the United States Patent and Trademark Office of a subset of the patents alleged to be infringed by Agilysys.

Table of Contents

9. (Loss) Earnings per Share

The following data shows the amounts used in computing (loss) earnings per share and the effect on income and the weighted average number of shares of dilutive potential common shares.

(In thousands, except per share data)	Three months ended December 31,		Nine months ended December 31,	
	2015	2014	2015	2014
Numerator:				
Net loss	\$(1,673	) \$(2,715	) \$(2,227	) (6,071
Denominator:				
Weighted average shares outstanding	22,493	22,343	22,479	22,336
Loss per share - basic and diluted:				
Loss per share	\$(0.07	) \$(0.12	) \$(0.10	) \$(0.27
Anti-dilutive stock options, SSARs, restricted shares and performance shares	1,804	1,467	1,633	1,360

Basic (loss) earnings per share is computed as net income available to common shareholders divided by the weighted average basic shares outstanding. The outstanding shares used to calculate the weighted average basic shares excludes 455,574 and 479,268 of restricted shares at December 31, 2015 and 2014, respectively, as these shares were issued but were not vested and, therefore, not considered outstanding for purposes of computing basic earnings per share at the balance sheet dates.

Diluted (loss) earnings per share includes the effect of all potentially dilutive securities on earnings per share. We have stock options, stock-settled appreciation rights (SSARs) and unvested restricted shares that are potentially dilutive securities. When a loss is reported, the denominator of diluted earnings per share cannot be adjusted for the dilutive impact of share-based compensation awards because doing so would be anti-dilutive. Therefore, for the three months and six months ended December 31, 2015 and 2014, basic weighted-average shares outstanding were used in calculating the diluted net loss per share.

10. Share-based Compensation

We may grant non-qualified stock options, incentive stock options, stock-settled stock appreciation rights, restricted shares, and restricted share units for up to 3.0 million common shares under our 2011 Stock Incentive Plan (the 2011 Plan). The maximum number of shares subject to stock options or SSARs that may be granted to an individual in a calendar year is 800,000 shares, and the maximum number of shares subject to restricted shares or restricted share units that may be granted to an individual in a calendar year is 400,000 shares. The maximum aggregate number of restricted shares or restricted share units that may be granted under the 2011 Plan is 1.0 million.

We have a shareholder-approved 2006 Stock Incentive Plan (the 2006 Plan) and a 2000 Stock Incentive Plan that still have vested awards outstanding. Awards are no longer being granted from these incentive plans.

We may distribute authorized but unissued shares or treasury shares to satisfy share option and appreciation right exercises or restricted share and performance share awards.

We record compensation expense related to stock options, SSARs, restricted shares, and performance shares granted to certain employees and non-employee directors based on the fair value of the awards on the grant date. The fair

value of restricted share and performance share awards is based on the closing price of our common shares on the grant date. The fair value of stock option and SSARs awards is estimated on the grant date using the Black-Scholes-Merton option pricing

Table of Contents

model, which includes assumptions regarding the risk-free interest rate, dividend yield, life of the award, and the volatility of our common shares.

The following table summarizes the share-based compensation expense for options, SSARs, restricted and performance awards included in the Condensed Consolidated Statements of Operations:

	Three months ended December 31,		Nine months ended December 31,	
(In thousands)	2015	2014	2015	2014
Product development	\$326	\$259	\$802	\$669
Sales and marketing	46	42	38	74
General and administrative	546	460	1,478	1,085
Total share-based compensation expense	918	761	2,318	1,828

Stock Options

The following table summarizes the activity during the nine months ended December 31, 2015 for stock options awarded under the 2006 Plan and the 2000 Stock Incentive Plan:

	Number of Options	Weighted- Average Exercise Price (per share)	Remaining Contractual Term (in years)	Aggregate Intrinsic Value
(In thousands, except share and per share data)				
Outstanding at April 1, 2015	582,500	\$15.41		
Granted	—	—		
Exercised	—	—		
Cancelled/expired	(37,500)	13.57		
Outstanding and exercisable at December 31, 2015	545,000	\$15.54	0.4	\$—

Stock-Settled Stock Appreciation Rights

SSARs are rights granted to an employee to receive value equal to the difference in the price of our common shares on the date of the grant and on the date of exercise. This value is settled in common shares of Agilysys.

The following table summarizes the activity during the nine months ended December 31, 2015 for SSARs awarded under the 2011 Plan:

	Number of Rights	Weighted- Average Exercise Price (per right)	Remaining Contractual Term (in years)	Aggregate Intrinsic Value
(In thousands, except share and per share data)				
Outstanding at April 1, 2015	394,010	\$10.76		
Granted	443,827	9.35		
Exercised	(17,030)	7.44		
Forfeited	(13,567)	10.71		
Expired	(1,558)	14.43		
Outstanding at December 31, 2015	805,682	\$10.05	5.5	\$651
Exercisable at December 31, 2015	268,261	\$9.74	3.9	\$372

As of December 31, 2015, total unrecognized stock based compensation expense related to non-vested SSARs was \$2.2 million, which is expected to be recognized over a weighted-average vesting period of 2.04 years.

Table of Contents

A total of 2,499 shares, net of 892 shares withheld to cover the employee's minimum applicable income taxes, were issued from treasury shares to settle SSARs exercised during the nine months ended December 31, 2015. The shares withheld were returned to treasury shares.

Restricted Shares

We granted shares to certain of our Directors, executives and key employees under the 2011 Plan, the vesting of which is service-based. The following table summarizes the activity during the nine months ended December 31, 2015 for restricted shares awarded under the 2011 Plan:

	Number of Shares	Weighted- Average Grant- Date Fair Value (per share)
(In thousands, except share and per share data)		
Outstanding at April 1, 2015	322,086	\$13.49
Granted	183,274	9.34
Vested	(25,487)	) 10.70
Forfeited	(32,111)	) 13.06
Outstanding at December 31, 2015	447,762	\$11.98

The weighted-average grant date fair value of the restricted shares is determined based upon the closing price of our common shares on the grant date. As of December 31, 2015, total unrecognized stock based compensation expense related to non-vested restricted stock was \$3.4 million, which is expected to be recognized over a weighted-average vesting period of 1.59 years.

Performance Shares

The following table summarizes the activity during the nine months ended December 31, 2015 for performance shares awarded under the 2011 Plan:

	Number of Shares	Weighted- Average Grant- Date Fair Value (per share)
Outstanding at April 1, 2015	—	\$—
Granted	7,812	9.60
Outstanding at December 31, 2015	7,812	\$9.60

The weighted-average grant date fair value of the performance shares is determined based upon the closing price of our common shares on the grant date and assumed that performance goals would be met at target. As of December 31, 2015, total unrecognized stock based compensation expense related to non-vested performance shares was \$0.1 million, which is expected to be recognized over a weighted-average vesting period of 0.61 years.

Table of Contents

11. Fair Value Measurements

We estimate the fair value of financial instruments using available market information and generally accepted valuation methodologies. We assess the inputs used to measure fair value using a three-tier hierarchy. The hierarchy indicates the extent to which pricing inputs used in measuring fair value are observable in the market. Level 1 inputs include unadjusted quoted prices for identical assets or liabilities and are the most observable. Level 2 inputs include unadjusted quoted prices for similar assets and liabilities that are either directly or indirectly observable, or other observable inputs such as interest rates, foreign currency exchange rates, commodity rates, and yield curves. Level 3 inputs are not observable in the market and include our own judgments about the assumptions market participants would use in pricing the asset or liability. The use of observable and unobservable inputs is reflected in the hierarchy assessment disclosed in the tables below.

There were no significant transfers between Levels 1, 2, and 3 during the nine months ended December 31, 2015 and 2014.

The following tables present information about our financial assets and liabilities measured at fair value on a recurring basis and indicate the fair value hierarchy of the valuation techniques utilized to determine such fair value:

	Fair value measurement used			
	Recorded value as of	Active markets for identical assets or liabilities	Quoted prices in similar instruments and observable inputs	Active markets for unobservable inputs
(In thousands)	December 31, 2015	(Level 1)	(Level 2)	(Level 3)
Assets:				
Corporate-owned life insurance — non-current	\$2,564			\$2,564
Liabilities:				
Contingent consideration — current	\$43			\$43
Contingent consideration — non-current	61			61

	Fair value measurement used			
	Recorded value as of	Active markets for identical assets or liabilities	Quoted prices in similar instruments and observable inputs	Active markets for unobservable inputs
(In thousands)	March 31, 2015	(Level 1)	(Level 2)	(Level 3)
Assets:				
Corporate-owned life insurance — non-current	2,493	—	—	2,493
Liabilities:				
Contingent consideration — current	8	—	—	8
Contingent consideration — non-current	104	—	—	104

The recorded value of the corporate-owned life insurance policies is adjusted to the cash surrender value of the policies obtained from the third party life insurance providers, which are not observable in the market, and therefore, are classified within Level 3 of the fair value hierarchy. Changes in the cash surrender value of these policies are recorded within “Other (income) expense, net” in the Condensed Consolidated Statements of Operations.

The fair value of the contingent consideration was determined by calculating the probability-weighted earn-out payments based on the assessment of the likelihood that certain milestones would be achieved.

Table of Contents

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

(In thousands)	Nine months ended December 31,	
	2015	2014
Corporate-owned life insurance:		
Balance on April 1	\$2,493	\$4,360
Unrealized (loss) gain relating to instruments held at reporting date	6	25
Purchases, sales, issuances and settlements, net	65	45
Proceeds from corporate-owned life insurance policy	—	(1,989)
Balance on December 31	\$2,564	\$2,441

The following tables present a summary of changes in the fair value of the Level 3 liabilities:

(In thousands)	Nine months ended December 31,	
	2015	2014
Contingent consideration		
Balance on April 1	\$112	\$1,739
Activity, payments and other charges (net)	(8)	(6)
Balance on December 31	\$104	\$1,733

Table of Contents

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

In “Management’s Discussion and Analysis of Financial Condition and Results of Operations” (“MD&A”), management explains the general financial condition and results of operations for Agilysys and subsidiaries including:

- what factors affect our business;
- what our earnings and costs were;
- why those earnings and costs were different from the year before;
- where the earnings came from;
- how our financial condition was affected; and
- where the cash will come from to fund future operations.

The MD&A analyzes changes in specific line items in the Condensed Consolidated Statements of Operations and Condensed Consolidated Statements of Cash Flows and provides information that management believes is important to assessing and understanding our consolidated financial condition and results of operations. This Quarterly Report on Form 10-Q updates information included in our Annual Report on Form 10-K for the fiscal year ended March 31, 2015, filed with the Securities and Exchange Commission (SEC). This discussion should be read in conjunction with the Condensed Consolidated Financial Statements and related Notes that appear in Item 1 of this Quarterly Report as well as our Annual Report for the year ended March 31, 2015. Information provided in the MD&A may include forward-looking statements that involve risks and uncertainties. Many factors could cause actual results to be materially different from those contained in the forward-looking statements. See “Forward-Looking Information” on page 31 of this Quarterly Report, Item 1A “Risk Factors” in Part II of this Quarterly Report, and Item 1A “Risk Factors” in Part I of our Annual Report for the fiscal year ended March 31, 2015 for additional information concerning these items. Management believes that this information, discussion, and disclosure is important in making decisions about investing in Agilysys.

Overview

Agilysys is a leading technology company that provides innovative software for point-of-sale (POS), property management, inventory and procurement, workforce management, analytics, document management and mobile and wireless solutions and services to the hospitality industry. Our solutions and services allow property managers to better connect, interact and transact with their customers and enhance their customer relationships by streamlining operations, improving efficiency, increasing guest recruitment and wallet share, and enhancing the overall guest experience. Agilysys serves four major market sectors: Gaming, both corporate and tribal; Hotels, Resorts and Cruise; Foodservice Management; and Restaurants, Universities, Stadia and Healthcare. A significant portion of our consolidated revenue is derived from contract support, maintenance and subscription services.

Agilysys operates extensively throughout North America, Europe and Asia, with corporate services located in Alpharetta, GA, and offices in Singapore, Hong Kong and Malaysia. Agilysys is comprised of a single operating segment and operates as a pure play software-driven solutions provider to the hospitality industry.

Our top priority is increasing shareholder value by improving operating and financial performance and profitability growing the business through superior products and services. To that end, we expect to invest a certain portion of our cash on hand to develop and market new software products, to fund enhancements to existing software products, to expand our customer breadth, both vertically and geographically, and to make select acquisitions.

The primary objective of our ongoing strategic planning process is to create shareholder value by exploiting growth opportunities and strengthening our competitive position within the specific technology solutions and in the end markets we service. The plan builds on our existing strengths and targets industry leading growth and peer beating

financial and operating results driven by new technology trends and market opportunities. Industry leading growth and peer beating financial and operational results will be achieved through tighter coupling and management of operating expenses of the business and sharpening the focus of our investments to concentrate on growth opportunities with the highest return by seeking the highest margin revenue opportunities in the markets in which we compete.

Our strategic plan specifically focuses on:

19

Table of Contents

- Strong customer focus, with clear and realistic service commitments.
- Growing sales of our proprietary solutions: products, support, maintenance and subscription services and professional services.
- Diversifying our customer base across industries and geographies.
- Capitalizing on our intellectual property and emerging technology trends.

Revenue - Defined

As required by the SEC, we separately present revenue earned as products revenue, support, maintenance and subscription services revenue or professional services revenue in our Consolidated Statements of Operations. In addition to the SEC requirements, we may, at times, also refer to revenue as defined below. The terminology, definitions, and applications of terms we use to describe our revenue may be different from those used by other companies and caution should be used when comparing these financial measures to those of other companies. We use the following terms to describe revenue:

- Revenue – We present revenue net of sales returns and allowances.
- Products revenue – Revenue earned from the sales of hardware equipment and proprietary and remarketed software.
- Support, maintenance and subscription services revenue – Revenue earned from the sale of proprietary and remarketed ongoing support, maintenance and subscription or hosting services.
- Professional services revenue – Revenue earned from the delivery of implementation, integration and installation services for proprietary and remarketed products.

Matters Affecting Comparability

No matters affecting comparability in the discussion and analysis presented below.

Table of Contents

Results of Operations

Third Fiscal Quarter 2016 Compared to Third Fiscal Quarter 2015

Net Revenue and Operating Loss

The following table presents our consolidated revenue and operating results for the three months ended December 31, 2015 and 2014:

(Dollars in thousands)	Three months ended December 31,		Increase (decrease)		
	2015	2014	\$	%	
Net revenue:					
Products	\$ 11,924	\$ 7,247	\$ 4,677	64.5	%
Support, maintenance and subscription services	14,896	13,920	976	7.0	%
Professional services	4,487	3,575	912	25.5	%
Total net revenue	31,307	24,742	6,565	26.5	%
Cost of goods sold:					
Products	6,991	4,413	2,578	58.4	%
Support, maintenance and subscription services	4,076	3,006	1,070	35.6	%
Professional services	3,732	3,194	538	16.8	%
Total cost of goods sold	14,799	10,613	4,186	39.4	%
Gross profit	16,508	14,129	2,379	16.8	%
Gross profit margin	52.7	% 57.1	%		
Operating expenses:					
Product development	6,969	6,670	299	4.5	%
Sales and marketing	4,618	3,696	922	24.9	%
General and administrative	5,517	5,175	342	6.6	%
Depreciation of fixed assets	569	556	13	2.3	%
Amortization of intangibles	321	617	(296)	(48.0)	)%
Restructuring, severance and other charges	8	95	(87)	nm	
Legal settlements	185	—	185	nm	
Operating loss	\$(1,679)	\$(2,680)	\$ 1,001	(37.4)	)%
Operating loss percentage	(5.4)	)% (10.8	)%		

nm - not meaningful

Table of Contents

The following table presents the percentage relationship of our Condensed Consolidated Statement of Operations line items to our consolidated net revenues for the periods presented:

	Three months ended December 31,			
	2015		2014	
Net revenue:				
Products	38.1	%	29.3	%
Support, maintenance and subscription services	47.6		56.3	
Professional services	14.3		14.4	
Total	100.0	%	100.0	%
Cost of goods sold:				
Products	22.3		17.8	
Support, maintenance and subscription services	13.0		12.1	
Professional services	11.9		12.9	
Total	47.3	%	42.9	%
Gross profit	52.7	%	57.1	%
Operating expenses:				
Product development	22.3		27.0	
Sales and marketing	14.8		14.9	
General and administrative	17.6		20.9	
Depreciation of fixed assets	1.8		2.2	
Amortization of intangibles	1.0		2.5	
Restructuring, severance and other charges	—		0.4	
Asset write-offs and other fair value adjustments	—		—	
Legal settlements	0.6		—	
Operating loss	(5.4	)%	(10.8	)%

Net revenue. Total net revenue increased \$6.6 million, or 26.5%, during the third quarter of fiscal 2016 compared to the third quarter of fiscal 2015. Products revenue increased \$4.7 million, or 64.5%, with a significant portion of the growth coming from increased sales related to our existing on-premise proprietary offerings, including hardware replacement sales, as well as increased new logo hardware sales related to our proprietary software sold as a service. Hardware and proprietary software revenue increased \$3.5 million, or 75.0%, and \$0.8 million, or 49.1%, respectively during the third quarter of fiscal 2016 compared to the third quarter of fiscal 2015. Support, maintenance and subscription services revenue increased \$1.0 million, or 7.0%, as a result of continued focus on selling hosted perpetual and subscription based service revenue which saw a 24.4% increase over the same period a year ago, and ongoing support from our proprietary product sales. Professional services revenue increased \$0.9 million, or 25.5%, as a result of increased volume of customer installation and implementation projects associated with growth in overall product revenue.

Gross profit and gross profit margin. Our total gross profit increased \$2.4 million, or 16.8%, for the third quarter of fiscal 2016 and total gross profit margin decreased approximately 440 basis points to 52.7%. Products gross profit increased \$2.1 million and gross profit margin increased approximately 230 basis points to 41.4% primarily as a result of \$0.1 million of software amortization benefit related to developed technology becoming fully amortized in the prior year period, offset by a higher mix of lower margin hardware sales. Support, maintenance and subscription services gross profit remained consistent and gross margin decreased 580 basis points to 72.6% as we continue to invest in our subscription platform. Professional services gross profit increased \$0.4 million and gross profit margin improved approximately 610 basis points to 16.8% primarily as a result of more efficient use of labor during the third quarter of fiscal 2016 as compared to the third quarter of fiscal 2015. During the third quarter of fiscal 2015 gross margin was

negatively impacted by increased labor costs required to meet certain customer expectations which resulted in subnormal blended utilization rates.

Table of Contents

Operating expenses

Operating expenses, excluding the charges for asset write-offs and other fair value adjustments, legal settlements and restructuring, severance and other charges, increased \$1.3 million, or 7.7%, in the third quarter of fiscal 2016 compared with the third quarter of fiscal 2015.

Product development. Product development includes all expenses associated with research and development. Product development increased \$0.3 million, or 4.5% in the third quarter of fiscal 2016 compared with the third quarter of fiscal 2015. This increase is primarily driven by our continued investment in resources related to both our rGuest® and non-rGuest® product enhancements to expand the customer experience across our install base as well as our future offerings with existing and new customers. In addition, certain research and development costs are capitalized as software development costs upon achieving specific milestones in the development life-cycle. We capitalized approximately \$3.4 million and \$4.5 million as software development costs for future use during the three months ended December 31, 2015 and 2014, respectively.

Sales and marketing. Sales and marketing increased \$0.9 million, or 24.9%, in the third quarter of fiscal 2016 compared with the third quarter of fiscal 2015. The change is due primarily to \$0.7 million of costs related to an increase in headcount of quota carrying salespeople and commission expense in line with revenue achievements during the third quarter of fiscal 2016 compared with the third quarter of fiscal 2015.

General and administrative. General and administrative increased \$0.3 million, or 6.6%, in the third quarter of fiscal 2016 compared with the third quarter of fiscal 2015 due primarily to \$0.2 of a loss on disposal of internal use software related to our support ticketing system and increases in legal professional service fees.

Amortization of intangibles. Amortization of intangibles decreased \$0.3 million or 48.0% in the third quarter of fiscal 2016 compared with the third quarter of fiscal 2015 primarily due to \$0.3 million of reduced expense in the third quarter of fiscal 2016 related to assets becoming fully amortized and assets being replaced or impaired during fiscal 2015.

Legal settlements. During the third quarter of fiscal 2016, we recorded \$0.2 million in legal settlements primarily related to employment matters.

Other Expenses (Income)

(Dollars in thousands)	Three months ended		(Unfavorable) favorable		
	December 31, 2015	2014	\$	%	
Other (income) expense:					
Interest income	\$(21)	) \$(24)	) \$(3)	) (12.5	)%
Interest expense	8	7	(1)	(14.3	)%
Other expense, net	63	114	51	nm	
Total other expense (income), net	\$50	\$97	\$47	48.5	%

Interest income. Interest income consists of interest earned on investments in certificates of deposit, commercial paper and corporate bonds.

Interest expense. Interest expense consists of costs associated with capital leases and loans on corporate-owned life insurance policies. Interest expense remained flat in the third quarter of fiscal 2016 compared to the third quarter of fiscal 2015.

Other expense (income). Other expense (income) consists mainly of the impact of foreign currency due to movement of Asian and European currencies against the US dollar and gain or loss on corporate-owned life insurance policies.

Table of Contents

Income Taxes

(Dollars in thousands)	Three months ended December 31,		(Unfavorable) favorable	
	2015	2014	\$	%
Income tax benefit	\$(56)	\$(62)	\$(6)	nm
Effective tax rate	3.2	% 2.3	%	

nm - not meaningful

For the three months ended December 31, 2015, the effective tax rate was different than the statutory rate due primarily to the recognition of net operating losses as deferred tax assets, which were offset by increases in the valuation allowance, an adjustment to true-up indefinite-lived intangibles, a refunded settlement of an unrecognized tax benefit, foreign and state taxes, and other U.S. permanent book to tax differences.

For the three months ended December 31, 2014, the effective tax rate was different than the statutory rate due primarily to the decrease in unrecognized tax benefits attributable to the expiration of statute of limitations, recognition of net operating losses as deferred tax assets, which were offset by increases in the valuation allowance, and other U.S. permanent book to tax differences.

Although the timing and outcome of tax settlements are uncertain, it is reasonably possible that during the next 12 months a reduction in unrecognized tax benefits may occur in the range of zero to \$0.1 million of tax and zero to \$0.1 million of interest based on the outcome of tax examinations and as a result of the expiration of various statutes of limitations. We are routinely audited; due to the ongoing nature of current examinations in multiple jurisdictions, other changes could occur in the amount of gross unrecognized tax benefits during the next 12 months which cannot be estimated at this time.

We have recorded a valuation allowance offsetting substantially all of our deferred tax assets. The ultimate realization of deferred tax assets depends on the generation of future taxable income during the periods in which those temporary differences are deductible. Because of our losses in prior periods, management believes that it is more-likely-than-not that we will not realize the benefits of these deductible differences. The amount of valuation allowance, however, could be reduced in the near term. The exact timing will be based on the level of profitability we achieve. We expect a full release of the valuation allowance associated with deferred tax assets in Hong Kong. We expect that the release of the valuation allowance will be recorded as an income tax benefit at the time of release increasing our reported net income. Our recorded tax rate may increase in subsequent periods following a valuation allowance release. Any valuation allowance release will not affect the amount of cash paid for income taxes.

Table of Contents

First Nine Months Fiscal 2016 Compared to First Nine Months Fiscal 2015

Net Revenue and Operating Loss

The following table presents our consolidated revenue and operating results for continuing operations for the nine months ended December 31, 2015 and 2014:

(Dollars in thousands)	Nine months ended December 31,		Increase (decrease)		
	2015	2014	\$	%	
Net revenue:					
Products	\$30,678	\$20,948	\$9,730	46.4	%
Support, maintenance and subscription services	44,460	41,514	2,946	7.1	%
Professional services	13,304	12,344	960	7.8	%
Total net revenue	88,442	74,806	13,636	18.2	%
Cost of goods sold:					
Products	17,035	11,414	5,621	49.2	%
Support, maintenance and subscription services	11,413	9,098	2,315	25.4	%
Professional services	9,496	8,823	673	7.6	%
Total cost of goods sold	37,944	29,335	8,609	29.3	%
Gross profit	50,498	45,471	5,027	11.1	%
Gross profit margin	57.1	% 60.8	%		
Operating expenses:					
Product development	20,021	18,726	1,295	6.9	%
Sales and marketing	14,396	11,407	2,989	26.2	%
General and administrative	15,897	16,369	(472)	(2.9)	)%
Depreciation of fixed assets	1,627	1,702	(75)	(4.4)	)%
Amortization of intangibles	937	2,994	(2,057)	(68.7)	)%
Restructuring, severance and other charges	(53)	) 913	(966)	) nm	
Asset write-offs and other fair value adjustments	(175)	) —	(175)	) nm	
Legal settlements	185	203	(18)	) nm	
Operating loss	\$(2,337)	) \$(6,843)	) \$4,506	(65.8)	)%
Operating loss percentage	(2.6)	)% (9.1	)%		

nm - not meaningful

Table of Contents

The following table presents the percentage relationship of our Condensed Consolidated Statement of Operations line items to our consolidated net revenues for the periods presented:

	Nine months ended December 31,			
	2015		2014	
Net revenue:				
Products	34.7	%	28.0	%
Support, maintenance and subscription services	50.3		55.5	
Professional services	15.0		16.5	
Total	100.0		100.0	
Cost of goods sold:				
Products	19.3		15.3	
Support, maintenance and subscription services	12.9		12.2	
Professional services	10.7		11.7	
Total	42.9		39.2	
Gross profit	57.1		60.8	
Operating expenses:				
Product development	22.6		25.0	
Sales and marketing	16.3		15.2	
General and administrative	18.0		21.9	
Depreciation of fixed assets	1.8		2.3	
Amortization of intangibles	1.1		4.0	
Restructuring, severance and other charges	(0.1)	)	1.2	
Asset write-offs and other fair value adjustments	(0.2)	)	—	
Legal settlements	0.2		0.3	
Operating loss	(2.6	)%	(9.1	)%

Net revenue. Total net revenue increased \$13.6 million or 18.2% during the first nine months of fiscal 2016 compared to the first nine months of fiscal 2015. Products revenue increased \$9.7 million, or 46.4%, with a significant portion of the growth coming from increased sales related to our existing on-premise proprietary offerings, including hardware replacement sales, as well as increased new logo hardware sales associated with our proprietary software sold as a service. Hardware and proprietary software revenue increased \$6.3 million, or 49.4%, and \$2.6 million, or 43.5%, respectively during the first nine months of fiscal 2016 compared to the first nine months of fiscal 2015. Support, maintenance and subscription services revenue increased \$2.9 million, or 7.1%, as a result of continued focus on selling subscription based hosting revenue, which was an increase of 27.3% year over year, and ongoing support from our growing product sales. Professional services revenue increased \$1.0 million, or 7.8% in the first nine months of fiscal 2016 compared to the first nine months of fiscal 2015 as a result of increased volume of customer installation and implementation projects associated with growth in overall product revenue.

Gross profit and gross profit margin. Our total gross profit increased 5.0 million, or 11.1%, for the first nine months of fiscal 2016 and total gross profit margin decreased 370 basis points to 57.1%. Products gross profit increased \$4.1 million and gross profit margin remained relatively flat decreasing 100 basis points to 44.5% primarily as a result of a higher mix of lower margin hardware sales, offset by \$0.2 million of software amortization benefit related to developed technology becoming fully amortized in the prior year period. Support, maintenance and subscription services gross profit increased \$0.6 million while gross margin decreased 380 basis points to 74.3% as we continue to invest in our subscription platform. Professional services gross margin increased \$0.3 million and gross profit margin remained consistent at 28.6%.

Table of Contents

Operating expenses

Operating expenses, excluding the charges for asset write-offs and other fair value adjustments, legal settlements and restructuring, severance and other charges, increased by \$1.7 million in the first nine months of fiscal 2016 compared to the first nine months of fiscal 2015.

Product development. Product development includes all expenses associated with research and development. Product development increased \$1.3 million, or 6.9% in the first nine months of fiscal 2016 compared to the first nine months of fiscal 2015. This increase is primarily driven by our continued investment in resources related to both our rGuest® and non-rGuest® product enhancements to expand the customer experience across our install base as well as our future offerings with existing and new customers. In addition, certain research and development costs are capitalized as software development costs upon achieving specific milestones in the development life-cycle. We capitalized approximately \$10.9 million and \$12.3 million during the nine months ended December 31, 2015 and December 31, 2014, respectively.

Sales and marketing. Sales and marketing increased \$3.0 million, or 26.2%, in the first nine months of fiscal 2016 compared to the first nine months of fiscal 2015. The change is due primarily to \$2.7 million of costs related to an increase in headcount of quota carrying salespeople and commission expense in line with revenue achievements during the first nine months of fiscal 2016 compared to the first nine months of fiscal 2015.

General and administrative. General and administrative decreased \$0.5 million, or 2.9%, in the first nine months of fiscal 2016 compared to the first nine months of fiscal 2015 due primarily to a reduction in spend related to system upgrades that occurred during the first half of fiscal 2015 and a reduction in discretionary expenses as we begin to yield the benefit from the restructuring activities announced in the fourth quarter of fiscal 2015.

Amortization of intangibles. Amortization of intangibles decreased \$2.1 million, or 68.7%, in the first nine months of fiscal 2016 compared to the first nine months of fiscal 2015. In October 2013, we initiated an internal ERP replacement project and determined that amortization for our existing ERP system should be accelerated. We recorded approximately \$0.9 million in the first half of fiscal 2015 of additional amortization in connection with this acceleration. The existing ERP system was fully amortized as of June 30, 2014. Additionally, \$1.1 million was recorded during the first nine months of fiscal 2015 related to assets becoming fully amortized and assets being replaced or impaired during fiscal 2015.

Restructuring, severance and other charges. In the second quarter of fiscal 2015, we implemented restructuring actions to better align product development, sales and marketing and general and administrative functions and to reduce operating costs and recorded \$0.2 million in restructuring charges related to the fiscal 2015 activities, comprised of severance and other employee related benefits. In addition, during the first nine months of fiscal 2015, we recorded \$0.4 million related to fiscal 2014 restructuring activities announced to better align corporate functions and to reduce operation costs following the sale of RSG. Non-restructuring severance and other charges during the first nine months of fiscal 2015 were approximately \$0.4 million.

Asset write-offs and other fair value adjustments. During the first nine months of fiscal 2016, we recorded a gain of \$0.2 million related to the write-off of product transition costs previously accrued for in connection with an impairment of our Guest 360™ property management solution in fiscal 2012. The customer associated with this residual reserve became insolvent during the second quarter of fiscal 2016.

Legal settlements. During each of the first nine months of fiscal 2016 and fiscal 2015, we recorded \$0.2 million in legal settlements for employment and other business related matters.

Table of Contents

Other (Income) Expenses

(Dollars in thousands)	Nine months ended		(Unfavorable) favorable		
	December 31, 2015	2014	\$	%	
Other (income) expense:					
Interest income	(70	) (98	) \$(28	) (28.6	)%
Interest expense	20	35	15	42.9	%
Other expense, net	40	68	28	41.2	%
Total other income (expense), net	\$(10	) \$5	\$15	nm	

Interest income. Interest income consists of interest earned on investments in certificates of deposit, commercial paper and corporate bonds.

Interest expense. Interest expense consists of costs associated with capital leases and loans on corporate-owned life insurance policies. Interest expense remained flat in the first nine months of fiscal 2016 compared to the first nine months of fiscal 2015.

Other (income) expense. Other (income) expense consists mainly of the impact of foreign currency due to movement of Asian and European currencies against the US dollar and gain or loss on corporate-owned life insurance policies.

Income Taxes

(Dollars in thousands)	Nine months ended		(Unfavorable) favorable		
	December 31, 2015	2014	\$	%	
Income tax benefit	\$(100	) \$(777	) \$(677	) nm	
Effective tax rate	4.3	% 11.4	%		

nm - not meaningful

For the first nine months of fiscal 2016, the effective tax rate was different than the statutory rate due primarily to the recognition of net operating losses as deferred tax assets, which were offset by increases in the valuation allowance, an adjustment to true-up indefinite-lived intangibles, a refunded settlement of an unrecognized tax benefit, foreign and state taxes, and other U.S. permanent book to tax differences.

For the first nine months of fiscal 2015, the effective tax rate was different than the statutory rate due primarily to the decrease in unrecognized tax benefits attributable to the expiration of statute of limitations, recognition of net operating losses as deferred tax assets, which were offset by increases in the valuation allowance, and other U.S. permanent book to tax differences.

Although the timing and outcome of tax settlements are uncertain, it is reasonably possible that during the next 12 months a reduction in unrecognized tax benefits may occur the range of zero to \$0.1 million of tax and zero to \$0.1 million of interest based on the outcome of tax examinations and as a result of the expiration of various statutes of limitations. We are routinely audited; due to the ongoing nature of current examinations in multiple jurisdictions, other changes could occur in the amount of gross unrecognized tax benefits during the next 12 months which cannot be estimated at this time.

We have recorded a valuation allowance offsetting substantially all of our deferred tax assets. The ultimate realization of deferred tax assets depends on the generation of future taxable income during the periods in which those temporary differences are deductible. Because of our losses in prior periods, management believes that it is more-likely-than-not that we will not realize the benefits of these deductible differences. The amount of valuation allowance, however,

could be reduced in the near term. The exact timing will be based on the level of profitability we achieve. We expect a full release of the valuation allowance associated with deferred tax assets in Hong Kong. We expect that the release of the valuation allowance will be recorded as an income tax benefit at the time of release increasing our reported net income. Our recorded tax rate may

Table of Contents

increase in subsequent periods following a valuation allowance release. Any valuation allowance release will not affect the amount of cash paid for income taxes.

Acquisitions

Purchase of assets from Dining Ventures - Fiscal 2015

On July 3, 2014, Agilysys purchased certain assets from Dining Ventures, Inc. The acquired assets are the base for our rGuest® Seat product, a dining reservations and table management application. The purchase consideration consisted of approximately \$3.8 million and was funded with cash on hand. Management concluded that this acquisition was not a material acquisition under the provisions of ASC 805, Business Combinations (ASC 805). The results derived from this purchased asset have been included in our Consolidated Financial Statements from the date of acquisition and did not have a material impact on our condensed consolidated financial statements or related disclosures.

The following is a summary of the fair values of the assets acquired in the acquisition:

(In thousands)

Goodwill	\$2,464
Developed technology	1,286
Total assets acquired	\$3,750

The goodwill of approximately \$2.5 million arising from the acquisition consists largely of synergies expected from combining the developed technology of Dining Ventures with Agilysys' operations. The goodwill from this acquisition is deductible for tax purposes over a period of 15 years.

The following is a summary of the intangible asset acquired and the weighted-average useful life over which it will be amortized.

	Purchased assets	Weighted-average useful life
Developed technology	\$1,286	5 years

The developed technology acquired from Dining Ventures was determined to be an internal use asset and is therefore carried in fixed assets on the balance sheet and amortized in operating expenses.

Liquidity and Capital Resources

Overview

Our operating cash requirements consist primarily of working capital needs, operating expenses, capital expenditures, and payments of principal and interest on indebtedness outstanding, which primarily consists of lease and rental obligations at December 31, 2015. We believe that cash flow from operating activities, cash on hand of \$65.7 million as of December 31, 2015 and access to capital markets will provide adequate funds to meet our short- and long-term liquidity requirements in the next 12 months.

As of December 31, 2015 and March 31, 2015, our total debt was approximately \$0.2 million, comprised of capital lease obligations in both periods.

At December 31, 2015, 100% of our cash and cash equivalents were deposited in bank accounts or invested in highly liquid investments with original maturities of three months or less. We maintain approximately 96% of our cash and cash equivalents in the United States. Therefore, we believe that credit risk is limited with respect to our cash and cash

equivalents.

29

Table of Contents

Cash Flow

(In thousands)	Nine months ended December 31,	
	2015	2014
Net cash provided by (used in):		
Operating activities	\$8,314	\$(7,469)
Investing activities	(17,170)	(22,545)
Financing activities	\$(464)	\$(289)
Effect of exchange rate changes on cash	(95)	(154)
Net decrease in cash and cash equivalents	\$(9,415)	\$(30,457)

Cash flow provided by (used in) operating activities. Cash flows provided by operating activities was \$8.3 million in the first nine months of fiscal 2016. The use of cash was attributable to \$5.3 million in net working capital movements associated mainly with \$4.5 million in increased collections on accounts receivable partially associated with the timing of annual support billings, \$5.5 million increase deferred revenue related to support services, offset by increases in inventory and other prepaid expenses of \$4.5 million. Working capital movements were positively impacted by \$3.5 million related to our operating loss adjusted for depreciation, amortization, share based compensation, asset write-offs and fair value adjustments, and loss on disposal of property & equipment.

Cash flows used in operating activities were \$7.5 million in the first nine months of fiscal 2015. The use of cash was mostly attributable to \$1.7 million in legal settlement payments, \$3.8 million for working capital movements related to the timing of bonus payments and payments to vendors, \$4.5 million from deferred revenue for support services performed during the period. This was partially offset by \$2.3 million related to collections of customer receivables.

Cash flow used in investing activities. In fiscal 2016, the \$17.2 million in cash used in investing activities was primarily comprised of \$13.5 million for the development of proprietary software and \$3.6 million for purchase of property and equipment, including internal use software.

In fiscal 2015, the \$22.5 million in cash used in investing activities was primarily comprised of \$5.1 million in net purchases of marketable securities, \$3.9 million for acquisition of developed technology for our rGuest® Seat product, \$3.9 million used for the new ERP replacement project and purchase of property and equipment and \$12.5 million for the development of proprietary software. This was partially offset by \$2.0 million in proceeds received from a company owned life insurance policy.

Cash flow used in financing activities. During the first nine months of fiscal 2016, the \$0.5 million used in financing activities was primarily comprised of the repurchase of shares to satisfy employee tax withholding and to cover the price of the options, and payments on capital lease obligations.

During the first nine months of fiscal 2015, the \$0.3 million used in financing activities was primarily comprised of the repurchase of shares to satisfy employee tax withholding and to cover the price of the options, and payments on capital lease obligations.

Contractual Obligations

As of December 31, 2015, there were no other significant changes to our contractual obligations as presented in our Annual Report for the year ended March 31, 2015.

Off-Balance Sheet Arrangements

We have not entered into any off-balance sheet arrangements that have had or are reasonably likely to have a current or future effect on our financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures, or capital resources.

Critical Accounting Policies

A detailed description of our significant accounting policies is included in our Annual Report for the year ended March 31, 2015. There have been no material changes in our significant accounting policies and estimates since March 31, 2015 except as noted in Note 2, Summary of Significant Accounting Policies.

Forward-Looking Information

This Quarterly Report and other publicly available documents, including the documents incorporated herein and therein by reference, contain, and our officers and representatives may from time to time make, "forward-looking statements" within the meaning of the safe harbor provisions of the U.S. Private Securities Litigation Reform Act of 1995. Forward-looking statements can be identified by words such as: "anticipate," "intend," "plan," "goal," "seek," "believe," "project," "estimate," "expect," "strategy," "future," "likely," "may," "should," "will" and similar references to future periods. These statements are not guarantees of future performance and involve risks, uncertainties, and assumptions that are difficult to predict. These statements are based on management's current expectations, intentions, or beliefs and are subject to a number of factors, assumptions, and uncertainties that could cause actual results to differ materially from those described in the forward-looking statements. Factors that could cause or contribute to such differences or that might otherwise impact the business include the risk factors set forth in Item 1A in Part II of this Quarterly Report and Item 1A of our Annual Report for the fiscal year ended March 31, 2015. We undertake no obligation to update any such factor or to publicly announce the results of any revisions to any forward-looking statements contained herein whether as a result of new information, future events, or otherwise.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

For quantitative and qualitative disclosures about market risk affecting us, see Item 7A, "Quantitative and Qualitative Disclosures About Market Risk," contained in our Annual Report for the fiscal year ended March 31, 2015. There have been no material changes in our market risk exposures since March 31, 2015.

Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

Management of the Company, with the participation of our Chief Executive Officer ("CEO") and Chief Financial Officer ("CFO"), evaluated the effectiveness of our disclosure controls and procedures (as defined under Rules 13a-15(e) and 15d-15(e) promulgated under the Securities Exchange Act of 1934, as amended) as of the end of the period covered by this Form 10-Q. Based on their evaluation, as of the end of the period covered by this Form 10-Q, our management, including the CEO and CFO, concluded that our disclosure controls and procedures were not effective as of December 31, 2015 because of the material weaknesses in our internal control over financial reporting described further below.

A material weakness is a deficiency, or a combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the Company's annual or interim financial statements will not be prevented or detected on a timely basis.

We did not maintain effective controls over the valuation of indefinite-lived intangible assets and capitalized software assets. Specifically, we did not design and maintain effective controls related to the review of significant assumptions used in the related impairment tests. While this control deficiency did not result in a material misstatement of previously filed annual or interim consolidated financial statements, the deficiency could result in misstatements of the aforementioned accounts and disclosures that would result in a material misstatement of the annual or interim

consolidated financial statements that would not be prevented or detected. Accordingly, management has determined that this control deficiency constituted a material weakness.

Also in February 2016, our management evaluated multiple out of quarter adjustments that were not detected and corrected on a timely basis by our review controls in fiscal year 2016, including those described under the heading “Correction of Errors” in Note 1 to our consolidated financial statements above. While these out of quarter adjustments were not material individually and in the aggregate to the consolidated financial statements, these adjustments indicate that our review controls in certain areas requiring complex manual calculations and application of certain complex accounting matters are not operating effectively. In aggregate, this control deficiency suggests an underlying risk that a material misstatement of the annual or interim consolidated financial statements would not be prevented or detected on a timely basis. Accordingly, management has determined that this control deficiency constituted a material weakness.

Remediation

We have begun to put additional controls in place relating to our review of significant assumptions used in the valuation of the indefinite-lived intangibles and capitalized software development cost assets, including designing, documenting, and implementing additional control procedures related to the review of the assumptions and data inputs used in the analyses, as well as assessing the overall results of the impairment analyses. As part of this process, we are refining our models and ensuring supporting evidence of detailed assumptions is retained and reviewed with the appropriate level of precision.

In response to the fiscal year 2016 out of quarter adjustments, management has implemented organizational changes designed to streamline roles and enhance the precision of review control procedures in certain areas that require complex manual calculations, such as fair value allocation for support revenue and capitalization of internal labor hours, and ensure management documentation for the application of certain complex accounting matters is sufficient to satisfy the objective of the related review controls and their timely execution.

Our management believes the foregoing efforts will effectively remediate the material weaknesses. As we continue to evaluate and work to improve our internal control over financial reporting, our management may execute additional measures to address the material weaknesses or modify the remediation plan described and will continue to review and make necessary changes to the overall design of our internal controls.

Change in Internal Control over Financial Reporting

There have been no changes in internal control over financial reporting during the quarter ended December 31, 2015 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

None.

Item 1A. Risk Factors

We have identified material weaknesses in our internal controls over financial reporting, and our business may be adversely affected if we do not adequately address those weaknesses or if we have other material weaknesses or significant deficiencies in our internal control over financial reporting.

We have concluded that our disclosure controls and procedures were not effective as of March 31, 2015, and December 31, 2015, because of material weaknesses in our internal control over financial reporting.

We did not adequately design and maintain effective controls related to the review of significant assumptions used in the impairment tests related to the valuation of indefinite-lived intangible assets and capitalized software assets. Also, multiple out of quarter adjustments that were not detected and corrected on a timely basis by our review controls in fiscal year 2016 indicate that certain of our review controls are not operating effectively. While these control deficiencies did

not result in a material misstatement of previously filed annual or interim consolidated financial statements, these control deficiencies suggest an underlying risk that a material misstatement of the annual or interim consolidated financial statements would not be prevented or detected on a timely basis.

The existence of these or one or more other material weaknesses or significant deficiencies could result in errors in our financial statements, and substantial costs and resources may be required to address these and any other internal control deficiencies. If we cannot produce reliable financial reports, investors could lose confidence in our reported financial information, the market price of our stock could decline significantly, and our business and operating results could be materially and adversely affected.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

None.

Item 3. Defaults Upon Senior Securities

None.

Item 4. Mine Safety Disclosures

Not applicable.

Item 5. Other Information

None.

Item 6. Exhibits

31.1 Rule 13a-14(a)/15d-14(a) Certification of Chief Executive Officer.

31.2 Rule 13a-14(a)/15d-14(a) Certification of Chief Financial Officer.

32.1 Certification of Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of Sarbanes-Oxley Act of 2002.

32.2 Certification of Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of Sarbanes-Oxley Act of 2002.

101 The following materials from our quarterly report on Form 10-Q for the quarter ended December 31, 2015, formatted in XBRL (Extensible Business Reporting Language): (i) Condensed Consolidated Balance Sheets at December 31, 2015 and March 31, 2015, (ii) Condensed Consolidated Statements of Operations for the three and nine months ended December 31, 2015 and 2014, (iii) Condensed Consolidated Statements of Comprehensive (Loss) Income for the three and nine months ended December 31, 2015 and 2014, (iv) Condensed Consolidated Statements of Cash Flows for the nine months ended December 31, 2015 and 2014, and (v) Notes to Condensed Consolidated Financial Statements for the three and nine months ended December 31, 2015.

SIGNATURE

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this Quarterly Report to be signed on its behalf by the undersigned thereunto duly authorized.

AGILYSYS, INC.

Date: February 9, 2016

/s/ Janine K. Seebeck
Janine K. Seebeck
Senior Vice President, Chief Financial Officer and
Treasurer
(Principal Accounting Officer and Duly Authorized Officer)