

**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 September 30, 2020

OR

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

Commission file number 001-35525

SMITH MICRO SOFTWARE, INC.

(Exact name of registrant as specified in its charter)

DELAWARE

(State or other jurisdiction of
incorporation or organization)

33-0029027

(I.R.S. Employer
Identification No.)

**5800 CORPORATE DRIVE
PITTSBURGH, PA 15237**

(Address of principal executive offices, including zip code)

(412) 837-5300

(Registrant's telephone number, including area code)

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

| Title of each class | Trading Symbol(s) | Name of each exchange on which registered |
|-------------------------------------------|----------------------|-------------------------------------------|
| Common Stock, par value \$0.001 per share | SMSI | NASDAQ |

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 every Interactive Data File required to be submitted 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 such files). Yes ☒ No ☐

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, a smaller reporting company, or an emerging growth company. See the definitions of "large accelerated filer," "accelerated filer," "smaller reporting company," and "emerging growth company" in Rule 12b-2 of the Exchange Act.

| | | | |
|-------------------------|--------------------------|---------------------------|-------------------------------------|
| Large accelerated filer | <input type="checkbox"/> | Accelerated filer | <input checked="" type="checkbox"/> |
| Non-accelerated filer | <input type="checkbox"/> | Smaller reporting company | <input checked="" type="checkbox"/> |
| Emerging growth company | <input type="checkbox"/> | | |

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act. ☐

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

As of November 5, 2020, there were 41,295,351 shares of common stock outstanding.

SMITH MICRO SOFTWARE, INC.
QUARTERLY REPORT ON FORM 10-Q
SEPTEMBER 30, 2020

TABLE OF CONTENTS

PART I. FINANCIAL INFORMATION

| | | |
|---------|----------------------------------------------------------------------------------------------------------------|----|
| Item 1. | Financial Statements (Unaudited) | 2 |
| | Consolidated Balance Sheets as of September 30, 2020 and December 31, 2019 | 2 |
| | Consolidated Statements of Operations for the Three and Nine Months Ended September 30, 2020 and 2019 | 3 |
| | Consolidated Statement of Stockholders' Equity for the Three and Nine Months Ended September 30, 2020 and 2019 | 4 |
| | Consolidated Statements of Cash Flows for the Nine Months Ended September 30, 2020 and 2019 | 6 |
| | Notes to the Consolidated Financial Statements | 7 |
| Item 2. | Management's Discussion and Analysis of Financial Condition and Results of Operations | 16 |
| Item 4. | Controls and Procedures | 20 |

PART II. OTHER INFORMATION

| | | |
|----------|-------------------------------------------------------------|----|
| Item 1. | Legal Proceedings | 21 |
| Item 1A. | Risk Factors | 21 |
| Item 2. | Unregistered Sales of Equity Securities and Use of Proceeds | 22 |
| Item 6. | Exhibits | 23 |

| | |
|-------------------|----|
| SIGNATURES | 24 |
|-------------------|----|

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

SMITH MICRO SOFTWARE, INC. CONSOLIDATED BALANCE SHEETS (in thousands, except share and par value data)

| | September 30, 2020 (unaudited) | December 31, 2019 (audited) |
|-----------------------------------------------------------------------------------------------------------------------------------------------------------------|--------------------------------------|-----------------------------------|
| Assets | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 25,872 | \$ 28,268 |
| Accounts receivable, net of allowance for doubtful accounts and other adjustments of \$84 (2020) and \$253 (2019) | 9,797 | 10,894 |
| Prepaid expenses and other current assets | 1,329 | 802 |
| Total current assets | 36,998 | 39,964 |
| Equipment and improvements, net | 2,250 | 2,109 |
| Right-of-use assets | 6,090 | 6,464 |
| Deferred tax assets, net | 94 | 94 |
| Other assets | 441 | 234 |
| Intangible assets, net | 14,186 | 4,535 |
| Goodwill | 11,493 | 7,797 |
| Total assets | <u>\$ 71,552</u> | <u>\$ 61,197</u> |
| Liabilities and Stockholders' Equity | | |
| Current liabilities: | | |
| Accounts payable | \$ 1,855 | \$ 2,050 |
| Accrued payroll and benefits | 2,705 | 2,107 |
| Current operating lease liabilities | 1,407 | 1,221 |
| Other accrued liabilities | 260 | 244 |
| Deferred revenue | 1,561 | 98 |
| Total current liabilities | 7,788 | 5,720 |
| Non-current liabilities: | | |
| Operating lease liabilities | 5,121 | 5,774 |
| Deferred rent | 928 | 885 |
| Other long term liabilities | 83 | 134 |
| Total non-current liabilities | 6,132 | 6,793 |
| Commitments and contingencies | | |
| Stockholders' equity: | | |
| Common stock, par value \$0.001 per share; 100,000,000 shares authorized; 41,295,351 and 38,475,084 shares issued and outstanding (2020 and 2019, respectively) | 41 | 38 |
| Additional paid-in capital | 279,401 | 274,041 |
| Accumulated comprehensive deficit | (221,810) | (225,395) |
| Total stockholders' equity | 57,632 | 48,684 |
| Total liabilities and stockholders' equity | <u>\$ 71,552</u> | <u>\$ 61,197</u> |

See accompanying notes to the consolidated financial statements.

SMITH MICRO SOFTWARE, INC.
CONSOLIDATED STATEMENTS OF OPERATIONS
(in thousands, except per share data)

| | For the Three Months Ended September 30, | | For the Nine Months Ended September 30, | |
|------------------------------------------|---------------------------------------------|---------------------|--------------------------------------------|---------------------|
| | 2020 (unaudited) | 2019 (unaudited) | 2020 (unaudited) | 2019 (unaudited) |
| Revenues | \$ 12,629 | \$ 11,782 | \$ 38,883 | \$ 31,068 |
| Cost of revenues | 1,326 | 1,011 | 3,767 | 2,902 |
| Gross profit | 11,303 | 10,771 | 35,116 | 28,166 |
| Operating expenses: | | | | |
| Selling and marketing | 2,655 | 1,793 | 8,049 | 5,529 |
| Research and development | 5,446 | 3,063 | 13,774 | 8,487 |
| General and administrative | 2,997 | 2,396 | 9,741 | 7,522 |
| Restructuring expense | 9 | 39 | 19 | 154 |
| Total operating expenses | 11,107 | 7,291 | 31,583 | 21,692 |
| Operating income | 196 | 3,480 | 3,533 | 6,474 |
| Other income (expense): | | | | |
| Interest income, net | 7 | 87 | 94 | 117 |
| Gain on sale of software product | — | — | — | 483 |
| Other expense | 3 | — | 3 | (15) |
| Income before provision for income taxes | 206 | 3,567 | 3,630 | 7,059 |
| Provision for income tax expense | 45 | 0 | 45 | 8 |
| Net income | <u>\$ 161</u> | <u>\$ 3,567</u> | <u>\$ 3,585</u> | <u>\$ 7,051</u> |
| Earnings per share: | | | | |
| Basic | <u>\$ 0.00</u> | <u>\$ 0.10</u> | <u>\$ 0.09</u> | <u>\$ 0.21</u> |
| Diluted | <u>\$ 0.00</u> | <u>\$ 0.09</u> | <u>\$ 0.08</u> | <u>\$ 0.20</u> |
| Weighted average shares outstanding: | | | | |
| Basic | 41,351 | 36,094 | 40,656 | 33,170 |
| Diluted | 43,026 | 39,472 | 42,577 | 35,287 |
| Preferred dividends per share | <u>\$ —</u> | <u>\$ 70.50</u> | <u>\$ —</u> | <u>\$ 104.58</u> |

See accompanying notes to the consolidated financial statements.

Error! Reference source not found. SMITH MICRO SOFTWARE, INC.
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY
(in thousands)

| | Series B Preferred Stock | | Common Stock | | Additional Paid-in Capital | Accumulated Comprehensive Deficit | Total |
|---------------------------------------------------------------|--------------------------|--------|--------------|--------|----------------------------------|-----------------------------------------|-----------|
| | Shares | Amount | Shares | Amount | | | |
| BALANCE, June 30, 2020 (unaudited) | — | \$ — | 41,356 | \$ 41 | \$ 278,828 | \$ (221,971) | \$ 56,898 |
| Non-cash compensation recognized on stock options and ESPP | — | — | — | — | 19 | — | 19 |
| Restricted stock grants, net of cancellations | — | — | — | — | 792 | — | 792 |
| Cancellation of shares for payment of withholding tax | — | — | (66) | — | (254) | — | (254) |
| Employee stock purchase plan | — | — | 4 | — | 13 | — | 13 |
| Exercise of stock options | — | — | 1 | — | 3 | — | 3 |
| Net income | — | — | — | — | — | 161 | 161 |
| BALANCE, September 30, 2020 (unaudited) | — | \$ — | 41,295 | \$ 41 | \$ 279,401 | \$ (221,810) | \$ 57,632 |

| | Series B Preferred Stock | | Common Stock | | Additional Paid-in Capital | Accumulated Comprehensive Deficit | Total |
|---------------------------------------------------------------|--------------------------|--------|--------------|--------|----------------------------------|-----------------------------------------|-----------|
| | Shares | Amount | Shares | Amount | | | |
| BALANCE, December 31, 2019 (audited) | — | \$ — | 38,475 | \$ 38 | \$ 274,041 | \$ (225,395) | \$ 48,684 |
| Non-cash compensation recognized on stock options and ESPP | — | — | — | — | 48 | — | 48 |
| Restricted stock grants, net of cancellations | — | — | 1,000 | 1 | 2,203 | — | 2,204 |
| Cancellation of shares for payment of withholding tax | — | — | (242) | — | (1,122) | — | (1,122) |
| Employee stock purchase plan | — | — | 6 | — | 19 | — | 19 |
| Exercise of warrants | — | — | 2,047 | 2 | 4,194 | — | 4,196 |
| Exercise of stock options | — | — | 9 | — | 18 | — | 18 |
| Net income | — | — | — | — | — | 3,585 | 3,585 |
| BALANCE, September 30, 2020 (unaudited) | — | \$ — | 41,295 | \$ 41 | \$ 279,401 | \$ (221,810) | \$ 57,632 |

See accompanying notes to the consolidated financial statements.

SMITH MICRO SOFTWARE, INC.
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY
(in thousands)

| | Series B Preferred Stock | | Common Stock | | Additional | Accumulated | |
|------------------------------------------------------------|--------------------------|--------|--------------|--------|------------|---------------|-----------|
| | Shares | Amount | Shares | Amount | Paid-in | Comprehensive | Total |
| | | | | | Capital | Deficit | |
| BALANCE, June 30, 2019 (unaudited) | 1 | \$ — | 32,042 | \$ 32 | \$262,215 | \$ (232,581) | \$ 29,666 |
| Non-cash compensation recognized on stock options and ESPP | — | — | — | — | 10 | — | 10 |
| Restricted stock grants, net of cancellations | — | — | — | — | 340 | — | 340 |
| Cancellation of shares for payment of withholding tax | — | — | (38) | — | (191) | — | (191) |
| Employee stock purchase plan | — | — | 2 | — | 6 | — | 6 |
| Exercise of warrants | — | — | 5,301 | 5 | 11,398 | — | 11,403 |
| Exercise of stock options | — | — | 10 | — | 38 | — | 38 |
| Conversion of preferred stock to common stock | (1) | — | 1,171 | 1 | (1) | — | — |
| Preferred stock dividends | — | — | — | — | — | (52) | (52) |
| Net income | — | — | — | — | — | 3,567 | 3,567 |
| BALANCE, September 30, 2019 (unaudited) | — | \$ — | 38,488 | \$ 38 | \$273,815 | \$ (229,066) | \$ 44,787 |

| | Series B Preferred Stock | | Common Stock | | Additional | Accumulated | |
|-----------------------------------------------------------------------|--------------------------|--------|--------------|--------|------------|---------------|-----------|
| | Shares | Amount | Shares | Amount | Paid-in | Comprehensive | Total |
| | | | | | Capital | Deficit | |
| BALANCE, December 31, 2018 (audited) | 1 | \$ — | 28,242 | \$ 28 | \$256,626 | \$ (236,091) | \$ 20,563 |
| Non-cash compensation recognized on stock options and ESPP | — | — | — | — | 30 | — | 30 |
| Restricted stock grants, net of cancellations | — | — | 1,225 | 1 | 1,108 | — | 1,109 |
| Cancellation of shares for payment of withholding tax | — | — | (176) | — | (506) | — | (506) |
| Employee stock purchase plan | — | — | 4 | — | 10 | — | 10 |
| Common shares issued in stock offering, net of offering costs | — | — | — | — | (14) | — | (14) |
| Common shares issued in connection with Smart Retail acquisition, net | — | — | 2,699 | 3 | 5,126 | — | 5,129 |
| Exercise of warrants | — | — | 5,304 | 5 | 11,398 | — | 11,403 |
| Exercise of stock options | — | — | 10 | — | 38 | — | 38 |
| Conversion of preferred stock to common stock | (1) | — | 1,180 | 1 | (1) | — | — |
| Preferred stock dividends | — | — | — | — | — | (119) | (119) |
| Cumulative effect of adoption of ASC 842 | — | — | — | — | — | 93 | 93 |
| Net income | — | — | — | — | — | 7,051 | 7,051 |
| BALANCE, September 30, 2019 (unaudited) | — | \$ — | 38,488 | \$ 38 | \$273,815 | \$ (229,066) | \$ 44,787 |

See accompanying notes to the consolidated financial statements.

SMITH MICRO SOFTWARE, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands)

| | For the Nine Months Ended September 30, | |
|-----------------------------------------------------------------------------------|--------------------------------------------|---------------------|
| | 2020 (unaudited) | 2019 (unaudited) |
| Operating activities: | | |
| Net income | \$ 3,585 | \$ 7,051 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation and amortization | 2,676 | 997 |
| Non-cash lease expense | 805 | 730 |
| Restructuring costs | 19 | 154 |
| Provision for doubtful accounts and other adjustments to accounts receivable | (59) | 127 |
| Provision for excess and obsolete inventory | — | 1 |
| Loss on disposal of fixed assets | — | 6 |
| Stock based compensation | 2,252 | 1,139 |
| Gain in sale of software product | — | (483) |
| Changes in operating accounts: | | |
| Accounts receivable | 1,159 | (4,031) |
| Prepaid expenses and other assets | (530) | 52 |
| Accounts payable and accrued liabilities | (1,804) | (701) |
| Deferred revenue | 173 | (214) |
| Net cash provided by operating activities | 8,276 | 4,828 |
| Investing activities: | | |
| Acquisition of Smart Retail business, net | — | (3,974) |
| Acquisition of Circle operator business, net | (13,500) | — |
| Proceeds from sale of software product | — | 363 |
| Capital expenditures | (1,212) | (824) |
| Other investing activities | (193) | — |
| Net cash used in investing activities | (14,905) | (4,435) |
| Financing activities: | | |
| Proceeds from exercise of common stock warrants | 4,196 | 11,403 |
| Dividends paid on preferred stock | — | (119) |
| Other financing activities | 37 | 34 |
| Net cash provided by financing activities | 4,233 | 11,318 |
| Net increase (decrease) in cash and cash equivalents | (2,396) | 11,711 |
| Cash and cash equivalents, beginning of period | 28,268 | 12,159 |
| Cash and cash equivalents, end of period | <u>\$ 25,872</u> | <u>\$ 23,870</u> |
| Supplemental disclosures of cash flow information: | | |
| Cash paid for income taxes | \$ 82 | \$ 60 |
| Supplemental disclosures of non-cash activities: | | |
| Issuance of common stock in connection with Smart Retail acquisition | \$ — | \$ 5,129 |

See accompanying notes to the consolidated financial statements.

SMITH MICRO SOFTWARE, INC.
Notes to the Consolidated Financial Statements
(Unaudited)

1. The Company

Smith Micro Software, Inc. (“Smith Micro”, the “Company”, “we”, “us”, or “our”) develops software to simplify and enhance the mobile experience, providing solutions to some of the leading wireless and cable service providers around the world. From enabling the family digital lifestyle to providing powerful voice messaging capabilities, we strive to enrich today’s connected lifestyles while creating new opportunities to engage consumers via smartphones and consumer IoT devices. Our portfolio includes a wide range of products for creating, sharing and monetizing rich content, such as visual voice messaging, retail content display optimization and performance analytics on any product set.

2. Accounting Policies

Basis of Presentation

The accompanying interim consolidated balance sheet as of September 30, 2020, and the related consolidated statements of operations, stockholders’ equity and cash flows for each of the three and nine months ended September 30, 2020 and 2019, are unaudited. The unaudited consolidated financial statements have been prepared according to the rules and regulations of the Securities and Exchange Commission (“SEC”) and, therefore, certain information and disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States (“GAAP”) have been omitted.

In the opinion of management, the accompanying unaudited consolidated financial statements for the periods presented reflect all adjustments which are normal and recurring, and necessary to fairly state the financial position, results of operations, and cash flows of the Company. These unaudited consolidated financial statements should be read in conjunction with the audited financial statements included in our Annual Report on Form 10-K for the fiscal year ended December 31, 2019 filed with the SEC on March 13, 2020.

Intercompany balances and transactions have been eliminated in consolidation.

Operating results for the three and nine months ended September 30, 2020 are not necessarily indicative of the results that may be expected for any other interim period or for the fiscal year ending December 31, 2020.

Impact of COVID-19

In March 2020, the World Health Organization categorized coronavirus disease 2019 (COVID-19) as a pandemic, and the President of the United States declared the COVID-19 outbreak a national emergency. COVID-19 continues to spread throughout the United States and other countries across the world, and the duration and severity of its effects are currently unknown. While the response to the COVID-19 outbreak continues to rapidly evolve, it has led to stay-at-home orders and social distancing guidelines that have seriously disrupted activities in large segments of the economy.

During the second and third quarters of 2020, we saw a reduction in the number of SafePath® platform subscribers compared to March 2020, which we believe was driven by the COVID-19 related economic slowdown. The Company’s consolidated financial statements presented herein reflect estimates and assumptions made by management that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and reported amounts of revenue and expenses during the reporting periods presented. The severity of the impact of the COVID-19 pandemic on the Company’s business will depend on a number of factors, including, but not limited to, the duration and severity of the pandemic and the extent and severity of the impact on the Company’s customers, all of which are uncertain and cannot be predicted.

As the impact of the COVID-19 pandemic on the economy and the Company’s operations continues to evolve, we will continue to monitor the impact on the Company’s operations and, if needed, postpone non-essential capital expenditures, reduce operating costs, and substantially reduce discretionary spending.

Revenue Recognition

The Company adopted FASB ASC Topic No. 606, *Revenue from Contracts with Customers*, as of January 1, 2018, and recognizes the sale of goods and services based on the five-step analysis of transactions as provided in Topic 606, which requires an entity to 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 such goods and services.

In our Wireless segment, we transfer software licenses to our customers on a royalty free, non-exclusive, non-transferrable, limited use basis during the term of the agreement. In some instances, we perform customization services to ensure the software operates within our customer's operating platforms as well as the operating platforms of the mobile devices used by their end customers, before transferring the license. Revenue related to these services is recognized at a point in time upon acceptance of the software license by the customer. We also earn usage based revenue on our platforms. Usage based revenue is generated based on active licenses used by our customer's end customers, the provision of hosting services, revenue share based on media placements on our platform, and use of our cloud based services. We recognize our usage based revenue when we have completed our performance obligation and have the right to invoice the customer. This revenue is generally recognized monthly or quarterly. Finally, in this segment, we ratably recognize revenue over the contract period when customers pay in advance of our service delivery.

On February 12, 2020, we acquired certain assets from Circle (as defined in Note 3 below), including a source code license to Circle's parental control software solution and two customer contracts. Pursuant to these contracts, the customer parties thereto license the parental control software solution for distribution to their respective subscribers in designated markets. In each case, the contracts allow the customer to take possession of the software solution and to host it on their platform or with an independent third party hosting service provider without significant cost. We also provide significant services that are required by the customer to ensure they have the utility of the license. As the license to the software solution and the services we provide are highly interrelated, we have concluded that the license and our services are a single performance obligation. The license fee is earned and recognized on a pro-rata basis over the contract term based on our customer's continued use of the license and our services.

We also provide consulting services to develop customer-specified functionality that are generally not on our software development roadmap. We recognize revenue from our consulting services upon delivery and acceptance by the customer of our software enhancements and upgrades. For certain Wireless segment customers we provide maintenance and technology support services for which the customer either pays upfront or as we provide the services. When the customer pays upfront, we record the payments as contract liabilities and recognize revenue ratably over the contract period as this is our stand ready performance obligation that is satisfied ratably over the maintenance and technology services period.

We receive upfront payments from customers from services to be provided under our ViewSpot® contracts. The advance receipts are deferred and subsequently recognized ratably over the contract period. We also provide consulting services to configure ad hoc targeted promotional content for our customers upon request. These requests are driven by our customers' marketing initiatives and tend to be short term "bursts" of activity. We recognize these revenues upon delivery of the configured promotional content to the cloud platform.

For our Graphics products where we sell off-the-shelf software products with no customization or post sale technology support services, we recognize revenue at the time we transfer control of the product to the customer. This occurs upon shipment of the product or when the customer downloads the software from our website or website of our resellers. We offer a 30 day return option to our customers; a return reserve is established at the time revenue is recorded and the reserve is monitored and adjusted based on actual experience. Historically, returns have been insignificant.

Fair Value Measurements

The Company measures and discloses fair value measurements as required by FASB ASC Topic No. 820, *Fair Value Measurements and Disclosures*.

Fair value is an exit price, representing the amount that would be received to sell an asset, or paid to transfer a liability, in an orderly transaction between market participants. As such, fair value is a market-based measurement that is determined based on assumptions that market participants would use in pricing an asset or a liability. As a basis for considering such assumptions, the FASB establishes a three-tier value hierarchy, which prioritizes the inputs used in the valuation methodologies in measuring fair value:

- Level 1 - Observable inputs that reflect quoted prices (unadjusted) for identical assets or liabilities in active markets
- Level 2 - Include other inputs that are directly or indirectly observable in the marketplace
- Level 3 - Unobservable inputs which are supported by little or no market activity

The fair value hierarchy also requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value.

As required by FASB ASC Topic No. 820, we measure our cash and cash equivalents at fair value. Our cash equivalents are classified within Level 1 by using quoted market prices utilizing market observable inputs.

As required by FASB ASC Topic No. 350, for goodwill and other intangibles impairment analysis, we utilize fair value measurements which are categorized within Level 3 of the fair value hierarchy.

3. Acquisitions

On February 12, 2020, the Company acquired the operator business of Circle Media Labs Inc. (“Circle”) pursuant to a certain Asset Purchase Agreement by and between the Company and Circle.

The following table summarizes the consideration paid for the Circle acquisition in 2020 (unaudited, in thousands):

| | | |
|-----------------------------------|----|---------------|
| Fair value of assets acquired | \$ | 14,966 |
| Fair value of liabilities assumed | | 1,466 |
| Total purchase price | \$ | <u>13,500</u> |
| Components of purchase price: | | |
| Cash | \$ | 12,150 |
| Cash holdback | | 1,350 |
| Total purchase price | \$ | <u>13,500</u> |

The Company’s preliminary allocation of the purchase price is summarized as follows (unaudited, in thousands):

| | | |
|-----------------------|----|---------------|
| Assets: | | |
| Inventory, net | \$ | 14 |
| Intangible assets | | 11,256 |
| Goodwill | | 3,696 |
| Total assets | \$ | <u>14,966</u> |
| Liabilities: | | |
| Deferred revenue | \$ | 1,290 |
| Amounts due to seller | | 176 |
| Total liabilities | | <u>1,466</u> |
| Total purchase price | \$ | <u>13,500</u> |

Pursuant to the transaction, Smith Micro acquired certain assets related to the Circle operator business, including two new customer contracts and a source code license to Circle’s then deployed parental control software and related technology.

Unaudited pro forma results of operations for the three and nine months ended September 30, 2020 and 2019 are included below as if the Circle acquisition occurred on January 1, 2019. This summary of the unaudited pro forma results of operations is not necessarily indicative of what the Company’s results of operations would have been had the operator business of Circle been acquired at the beginning of 2019, nor does it purport to represent results of operations for any future periods.

| | For the Three Months Ended September 30, | | For the Nine Months Ended September 30, | |
|---------------------|-----------------------------------------------------|-----------|-----------------------------------------------------|-----------|
| | 2020 | 2019 | 2020 | 2019 |
| | (unaudited, in thousands, except per share amounts) | | (unaudited, in thousands, except per share amounts) | |
| Revenues | \$ 12,629 | \$ 12,909 | \$ 39,350 | \$ 33,860 |
| Net income | 161 | 3,821 | 3,645 | 6,211 |
| Earnings per share: | | | | |
| Basic | \$ 0.00 | \$ 0.10 | \$ 0.09 | \$ 0.19 |
| Diluted | \$ 0.00 | \$ 0.10 | \$ 0.09 | \$ 0.18 |

4. Goodwill

In accordance with FASB ASC Topic No. 350, *Intangibles-Goodwill and Other*, we review the recoverability of the carrying value of goodwill at least annually or whenever events or circumstances indicate a potential impairment. The Company’s impairment testing will be performed annually at December 31. Recoverability of goodwill is determined by comparing the fair value of the Company’s reporting units to the carrying value of the underlying net assets in the reporting units. If the fair value of a reporting unit is determined to be less than the carrying value of its net assets, goodwill is deemed impaired and an impairment loss is recognized to the extent that the carrying value of goodwill exceeds the difference between the fair value of the reporting unit and the fair value of its other assets and liabilities. The Company determined that there was no goodwill impairment at September 30, 2020 and December 31, 2019.

5. Earnings Per Share

The Company calculates earnings per share (“EPS”) as required by FASB ASC Topic No. 260, *Earnings Per Share*. Basic EPS is calculated by dividing the net income available to common stockholders by the weighted average number of common shares outstanding for the period, excluding common stock equivalents. Diluted EPS is computed by dividing the net income available to common stockholders by the weighted average number of common shares outstanding for the period, plus the weighted average number of dilutive common stock equivalents outstanding for the period determined using the treasury-stock method. For periods with a net loss, the dilutive common stock equivalents are excluded from the diluted EPS calculation. For purposes of this calculation, common stock subject to repurchase by the Company, options, and warrants are considered to be common stock equivalents and are only included in the calculation of diluted earnings per share when their effect is dilutive.

The following table sets forth the details of basic and diluted earnings per share:

| | For the Three Months Ended September 30, | | For the Nine Months Ended September 30, | |
|----------------------------------------------------------------------|-----------------------------------------------------|-----------------|-----------------------------------------------------|-----------------|
| | 2020 | 2019 | 2020 | 2019 |
| | (unaudited, in thousands, except per share amounts) | | (unaudited, in thousands, except per share amounts) | |
| Numerator: | | | | |
| Net income | \$ 161 | \$ 3,567 | \$ 3,585 | \$ 7,051 |
| Dividends paid to preferred stockholders | — | (52) | — | (119) |
| Net income available to common stockholders | <u>\$ 161</u> | <u>\$ 3,515</u> | <u>\$ 3,585</u> | <u>\$ 6,932</u> |
| Denominator: | | | | |
| Weighted average shares outstanding – basic | <u>41,351</u> | <u>36,094</u> | <u>40,656</u> | <u>33,170</u> |
| Potential common shares – options / warrants (treasury stock method) | <u>1,675</u> | <u>3,378</u> | <u>1,921</u> | <u>2,117</u> |
| Weighted average shares outstanding – diluted | <u>43,026</u> | <u>39,472</u> | <u>42,577</u> | <u>35,287</u> |
| Shares excluded (anti-dilutive) | <u>101</u> | <u>67</u> | <u>101</u> | <u>131</u> |
| Net earnings per common share: | | | | |
| Basic | <u>\$ 0.00</u> | <u>\$ 0.10</u> | <u>\$ 0.09</u> | <u>\$ 0.21</u> |
| Diluted | <u>\$ 0.00</u> | <u>\$ 0.09</u> | <u>\$ 0.08</u> | <u>\$ 0.20</u> |

6. Stock-Based Compensation

Stock Plans

During the three and nine months ended September 30, 2020, the Company granted 0 and 1,000,000 shares of restricted stock, respectively, and incentive stock options exercisable for 0 and 22,000 shares, respectively, under the Company’s 2015 Omnibus Equity Incentive Plan, as amended (the “2015 Plan”). As of September 30, 2020, there were approximately 5.1 million shares available for future grants under the Company’s 2015 Plan.

7. Revenues

Revenue Recognition

We primarily sell our software solutions, cloud-based services and consulting services to major wireless network and cable operators. We sell our off-the-shelf Graphics software products directly to end users as well as through our distribution and reseller channel partners.

We recognize sales of goods and services based on the five-step analysis of transactions as provided in Topic 606. For all contracts with customers, we first identify the contract which usually is established when a contract is fully executed by each party and consideration is expected to be received. Next, we identify the performance obligations in the contract. A performance obligation is a promise in a contract to transfer a distinct good or service to the customer. We then determine the transaction price in the arrangement and allocate the transaction price, if necessary, to each performance obligation identified in the contract. The allocation of the transaction price to the performance obligations are based on the relative standalone selling prices for the goods and services contained in a particular performance obligation. The transaction price is adjusted for the Company's estimate of variable consideration which may include certain incentives and discounts, product returns, distributor fees, and storage fees. We evaluate the total amount of variable consideration expected to be earned by using the expected value method, as we believe this method represents the most appropriate estimate for this consideration, based on historical service trends, the individual contract considerations and our best judgment at the time. We include estimates of variable consideration in revenues only to the extent that it is probable that a significant reversal in the amount of cumulative revenue recognized will not occur when the uncertainty associated with the variable consideration is subsequently resolved. We also generate the majority of our revenue on usage based fees which are variable and depend entirely on our customers use of perpetual licenses, transactions processed on our hosted environment, advertisement placements on our service platform, and activity on our cloud based service platform. As discussed in Note 3, on February 12, 2020, we purchased two customer contracts from Circle. Under these contracts, we provide our customers with licenses to software solutions and related services, for which we earn license fees, managed and hosting service fees, and consulting services which are provided throughout the life of the licensing arrangement.

Our contracts with the Tier 1 customers include promises to transfer multiple products and services. Determining whether products and services are considered distinct performance obligations that should be accounted for separately versus together may require significant judgment. Our cloud-based service includes a software solution license integrated with cloud-based services. Judgment is required to determine whether the software license is considered distinct and accounted for separately, or not distinct and accounted for together with the cloud service and recognized over time. Since we do not allow our customers to take possession of the software solution, and since the utility of the license comes from the cloud-based services that we provide, we consider the software license and the cloud services to be single performance obligation. We provide the Circle software solution license together with highly integrated consulting services to generate the utility of the license to the customers. Since the software solution and consulting services provided are highly interrelated, we consider the license and the consulting services to be a single performance obligation.

We also provide consulting services to configure ad hoc targeted promotional content to be presented on our solutions as well as consulting services to provide additional functionality for our software solutions based on our customer's request. These requests are driven by our customer's marketing initiatives and tend to be short term "bursts" of activity or specific incremental functionality to existing software solutions. We recognize these revenues upon delivery and acceptance of the configured promotional content or additional functionality to the software solution.

We have made accounting policy elections to exclude all taxes by governmental authorities from the measurement of the transaction price, and since our standard payment terms are less than one year, we have elected the practical expedient not to assess whether a contract has a significant financing component.

Deferred Revenue

Deferred revenue represents amounts billed to customers for which revenue has not been recognized. Deferred revenue primarily consists of the unearned portion of monthly, quarterly and annually billed service fees and prepayments made by customers for a future period. We recognize revenue upon transfer of control. As of September 30, 2020, our total deferred revenue balance was \$1.6 million, of which \$1.5 million was related to the acquisition of the Circle operator business.

Disaggregation of Revenues

We disaggregate revenue by our Wireless and Graphics products.

Revenues on a disaggregated basis are as follows (in thousands):

| | For the Three Months Ended September 30, | | For the Nine Months Ended September 30, | |
|-------------------------------|------------------------------------------|-----------|-----------------------------------------|-----------|
| | 2020 | 2019 | 2020 | 2019 |
| | (unaudited) | | (unaudited) | |
| Wireless: | | | | |
| License and service fees | \$ 1,006 | \$ — | \$ 2,569 | \$ — |
| Hosted environment usage fees | 4,555 | 4,916 | 13,444 | 14,863 |
| Cloud based usage fees | 6,068 | 5,650 | 20,420 | 13,079 |
| Consulting services and other | 880 | 1,048 | 1,991 | 2,480 |
| Total wireless | \$ 12,509 | \$ 11,614 | \$ 38,424 | \$ 30,422 |
| Graphics: | | | | |
| Software | 120 | 168 | 459 | 646 |
| Total revenues | \$ 12,629 | \$ 11,782 | \$ 38,883 | \$ 31,068 |

8. Segment, Customer Concentration and Geographical Information

Segment Information

Public companies are required to report financial and descriptive information about their reportable operating segments as required by FASB ASC Topic No. 280, *Segment Reporting*. The Company has one primary business unit based on how management internally evaluates separate financial information, business activities and management responsibility: Wireless. The Wireless segment includes our SafePath®, CommSuite®, ViewSpot®, and NetWise® family of products.

The Company does not separately allocate operating expenses to these business units, nor does it allocate specific assets. Therefore, business unit information reported includes only revenues.

The following table presents the Wireless revenues by product (in thousands):

| | For the Three Months Ended September 30, | | For the Nine Months Ended September 30, | |
|-------------------------|------------------------------------------|-----------|-----------------------------------------|-----------|
| | 2020 | 2019 | 2020 | 2019 |
| | (unaudited) | | (unaudited) | |
| SafePath | \$ 6,755 | \$ 5,200 | \$ 21,948 | \$ 11,108 |
| CommSuite | 4,542 | 4,602 | 13,411 | 13,957 |
| ViewSpot | 1,157 | 1,260 | 2,873 | 3,673 |
| Netwise | 33 | 493 | 118 | 1,492 |
| Other | 22 | 59 | 74 | 192 |
| Total wireless revenues | \$ 12,509 | \$ 11,614 | \$ 38,424 | \$ 30,422 |

Customer Concentration Information

Revenues generated from our sales to Sprint and, subsequent to its April 2020 merger with Sprint, the combined T-Mobile, and their respective affiliates in the Wireless business segment accounted for 76% and 83% of the Company's total revenues for the three months ended September 30, 2020 and 2019, respectively, and 85% and 81% for the nine months ended September 30, 2020 and 2019, respectively. T-Mobile comprised 70% and Sprint comprised 80% of our accounts receivable as of September 30, 2020 and 2019, respectively.

Geographical Information

During the nine months ended September 30, 2020 and 2019, the Company operated in three geographic locations; the Americas, EMEA (Europe, the Middle East, and Africa), and Asia Pacific. Revenues attributed to the geographic location of the customers' bill-to address were as follows (in thousands):

| | For the Three Months Ended September 30, | | For the Nine Months Ended September 30, | |
|----------------|-------------------------------------------------|------------------|------------------------------------------------|------------------|
| | 2020 | 2019 | 2020 | 2019 |
| | (unaudited) | | (unaudited) | |
| Americas | \$ 12,045 | \$ 11,755 | \$ 37,451 | \$ 30,978 |
| EMEA | 581 | 18 | 1,411 | 56 |
| Asia Pacific | 3 | 9 | 21 | 34 |
| Total revenues | <u>\$ 12,629</u> | <u>\$ 11,782</u> | <u>\$ 38,883</u> | <u>\$ 31,068</u> |

The Company does not separately allocate specific assets to these geographic locations.

9. Commitments and Contingencies

Litigation

The Company may become involved in various legal proceedings arising from its business activities. While management does not believe the ultimate disposition of these matters will have a material adverse impact on the Company's consolidated results of operations, cash flows, or financial position, litigation is inherently unpredictable, and depending on the nature and timing of these proceedings, an unfavorable resolution could materially affect the Company's future consolidated results of operations, cash flows, or financial position in a particular period.

Other Contingent Contractual Obligations

During its normal course of business, the Company has made certain indemnities, commitments, and guarantees under which it may be required to make payments in connection with certain transactions. These include: intellectual property indemnities to the Company's customers and licensees in connection with the use, sale, and/or license of Company products; indemnities to various lessors in connection with facility leases for certain claims arising from use of such facility or under such lease; indemnities to vendors and service providers pertaining to claims based on the negligence or willful misconduct of the Company; indemnities involving the accuracy of representations and warranties in certain contracts; and indemnities to directors and officers of the Company to the maximum extent permitted under the laws of the State of Delaware. In addition, the Company has made contractual commitments to employees providing for severance payments upon the occurrence of certain prescribed events. The Company may also issue a guarantee in the form of a standby letter of credit as security for contingent liabilities under certain customer contracts. The duration of these indemnities, commitments, and guarantees varies, and in certain cases may be indefinite. The majority of these indemnities, commitments, and guarantees may not provide for any limitation of the maximum potential for future payments the Company could be obligated to make. The Company has not recorded any liability for these indemnities, commitments, and guarantees in the accompanying consolidated balance sheets.

10. Leases

The Company leases office space and equipment, and certain office space is subleased. Management determines if a contract is a lease at the inception of the arrangement and reviews all options to extend, terminate, or purchase its right-of-use assets at the inception of the lease and accounts for these options when they are reasonably certain of being exercised.

Leases with an initial term of greater than twelve months are recorded on the consolidated balance sheet. Lease expense is recognized on a straight-line basis over the lease term.

The Company's lease contracts generally do not provide a readily determinable implicit rate. For these contracts, the estimated incremental borrowing rate is based on information available at the inception of the lease.

Operating lease cost consists of the following (in thousands):

| | For the Three Months Ended September 30, | | For the Nine Months Ended September 30, | |
|------------------|------------------------------------------|---------------|-----------------------------------------|-----------------|
| | 2020 | 2019 | 2020 | 2019 |
| | (unaudited) | | | |
| Lease cost | \$ 558 | \$ 518 | \$ 1,673 | \$ 1,553 |
| Sublease income | (151) | (151) | (452) | (452) |
| Total lease cost | <u>\$ 407</u> | <u>\$ 367</u> | <u>\$ 1,221</u> | <u>\$ 1,101</u> |

The maturity of operating lease liabilities is presented in the following table (in thousands):

| | As of September 30, 2020 (unaudited) |
|------------------------------------|-----------------------------------------|
| 2020 | \$ 450 |
| 2021 | 1,785 |
| 2022 | 1,535 |
| 2023 | 1,522 |
| 2024 | 1,182 |
| Thereafter | 1,158 |
| Total lease payments | 7,632 |
| Less imputed interest | (1,104) |
| Present value of lease liabilities | <u>\$ 6,528</u> |

Additional information relating to the Company's operating leases follows:

| | As of September 30, 2020 (unaudited) |
|-----------------------------------------------|-----------------------------------------|
| Weighted average remaining lease term (years) | 4.70 |
| Weighted average discount rate | 6.85% |

11. Income Taxes

We account for income taxes as required by FASB ASC Topic No. 740, *Income Taxes*. This Topic clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements and prescribes a recognition threshold and measurement process for financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. The Topic also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. The Topic requires an entity to recognize the financial statement impact of a tax position when it is more likely than not that the position will be sustained upon examination. The amount recognized is measured as the largest amount of benefit that is greater than fifty percent likely of being realized upon ultimate settlement. In addition, the Topic permits an entity to recognize interest and penalties related to tax uncertainties as either income tax expense or operating expenses. The Company has chosen to recognize interest and penalties related to tax uncertainties as income tax expense.

The Company assesses whether a valuation allowance should be recorded against its deferred tax assets based on the consideration of all available evidence, using a "more likely than not" realization standard. The four sources of taxable income that must be considered in determining whether deferred tax assets will be realized are: (1) future reversals of existing taxable temporary differences (i.e., offset of gross deferred tax liabilities against gross deferred tax assets); (2) taxable income in prior carryback years, if carryback is permitted under the applicable tax law; (3) tax planning strategies; and (4) future taxable income exclusive of reversing temporary differences and carryforwards.

In assessing whether a valuation allowance is required, significant weight is to be given to evidence that can be objectively verified. A significant factor in the Company's assessment is that the Company was in a five-year historical cumulative loss as of the end of fiscal 2018. These facts, combined with uncertain near-term market and economic conditions, reduced the Company's ability to rely on projections of future taxable income in assessing the realizability of its deferred tax assets.

After a review of the four sources of taxable income as of December 31, 2019, and after consideration of the Company's cumulative loss position as of December 31, 2019, the Company will continue to reserve its U.S.-based deferred tax amounts, which total \$50.4 million as of September 30, 2020.

The Company is subject to U.S. federal income tax as well as income tax of multiple state jurisdictions. Currently there are no audits in process or pending from Federal or state tax authorities. State income tax returns are subject to examination for a period of three to four years after filing. As of December 31, 2019, the company had no outstanding tax audits. The outcome of tax audits cannot be predicted with certainty. If any issues addressed in the Company's tax audits are resolved in a manner not consistent with management's expectations, the Company could be required to adjust its provision for income tax in the period such resolution occurs. We may from time to time be assessed interest or penalties by major tax jurisdictions, although any such assessments historically have been minimal and immaterial to our consolidated financial results. It is the Company's policy to classify any interest and/or penalties in the consolidated financial statements as a component of income tax expense.

On March 27, 2020, President Trump signed into U.S. federal law the Coronavirus Aid, Relief, and Economic Security Act (the "CARES Act"), which is aimed at providing emergency assistance and health care for individuals, families and businesses affected by the COVID-19 pandemic and generally supporting the U.S. economy. The CARES Act, among other things, includes provisions relating to refundable payroll tax credits, deferment of employer side social security payments, net operating loss carryback periods, alternative minimum tax credit refunds, modifications to the net interest deduction limitations and technical corrections to tax depreciation methods for qualified improvement property. In particular, under the CARES Act, (i) for taxable years beginning before 2021, net operating loss carryforwards and carrybacks may offset 100% of taxable income, (ii) NOLs arising in 2018, 2019 and 2020 taxable years may be carried back to each of the preceding five years to generate a refund and (iii) for taxable years beginning in 2019 and 2020, the base for interest deductibility is increased from 30% to 50% of EBITDA. We continue to analyze the different aspects of the CARES Act to determine whether any specific provisions may impact us.

12. Subsequent Events

The Company evaluates and discloses subsequent events as required by FASB ASC Topic No. 855, *Subsequent Events*. The Topic establishes general standards of accounting for and disclosure of events that occur after the balance sheet date, but before the financial statements are issued or are available to be issued. Subsequent events have been evaluated as of the date of this filing and no further disclosures are required.

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

In this document, the terms "Smith Micro," "Company," "we," "us," and "our" refer to Smith Micro Software, Inc. and, where appropriate, its subsidiaries.

This Quarterly Report on Form 10-Q ("Report") contains forward-looking statements regarding Smith Micro which include, but are not limited to, statements concerning customer concentration, projected revenues, market acceptance of products, the success and timing of new product introductions, the competitive factors affecting our business, our ability to raise additional capital, gross profit and income, our ability to remain a going concern, our expenses, and the protection of our intellectual property. These forward-looking statements are based on our current expectations, estimates and projections about our industry, management's beliefs, and certain assumptions made by us. Words such as "anticipates," "expects," "intends," "plans," "predicts," "potential," "believes," "seeks," "estimates," "should," "may," "will," and variations of these words or similar expressions are intended to identify forward-looking statements. Forward-looking statements also include the assumptions underlying or relating to any of the foregoing statements. These statements are not guarantees of future performance and are subject to risks, uncertainties, and assumptions that are difficult to predict. Therefore, our actual results could differ materially from those expressed or implied in any forward-looking statements as a result of various factors. Such factors include, but are not limited to, the following:

- our customer concentration given that the majority of our sales currently depend on a few large client relationships, including T-Mobile;
- the impact of the COVID-19 pandemic on our business and financial results;
- our ability to establish and maintain strategic relationships with our customers and mobile device manufacturers;
- intense competition in our industry and the core vertical markets in which we operate, and our ability to successfully compete;
- rapid technological evolution and resulting changes in demand for our products from our key customers and their end users;
- our ability to hire and retain key personnel;
- our ability to assimilate acquisitions without diverting management attention and impacting current operations;
- the possibility of security and privacy breaches in our systems damaging client relations and inhibiting our ability to grow;
- interruptions or delays in the services we provide from our data center hosting facilities that could harm our business;
- our ability to raise additional capital and the risk of such capital not being available to us at commercially reasonable terms or at all;
- our ability to become and remain profitable;
- the impact of evolving information security and data privacy laws on our business and industry;
- the impact of U.S. regulations on our business and industry;
- our ability to protect our intellectual property and our ability to operate our business without infringing on the rights of others;
- our ability to remain a going concern;
- the risks inherent with international operations;
- the risk of being delisted from NASDAQ if we fail to meet any of its applicable listing requirements;
- the existence of undetected software defects in our products;
- the availability of third-party intellectual property and licenses needed for our operations on commercially reasonable terms, or at all;
- changes in our operating income or loss due to shifts in our sales mix and variability in our operating expenses;
- the difficulty of predicting our quarterly revenues and operating results and the chance of such revenues and results falling below analyst or investor expectations, which could cause the price of our common stock to fall; and
- potential tax liabilities and other factors that may impact our effective tax rates.

The forward-looking statements contained in this Report are made on the basis of the views and assumptions of management regarding future events and business performance as of the date this Report is filed with the Securities and Exchange Commission (the “SEC”). In addition, we operate in a highly competitive and rapidly changing environment; therefore, new risk factors can arise, and it is not possible for management to predict all such risk factors, nor to assess the impact of all such risk factors on our business or the extent to which any individual risk factor, or combination of risk factors, may cause results to differ materially from those contained in any forward-looking statement. We do not undertake any obligation to update these statements to reflect events or circumstances occurring after the date this Report is filed.

Overview

Smith Micro develops software to simplify and enhance the mobile experience, providing solutions to some of the leading wireless and cable service providers around the world. From enabling the family digital lifestyle to providing powerful voice messaging capabilities, we strive to enrich today’s connected lifestyles while creating new opportunities to engage consumers via smartphones and consumer IoT devices. Our portfolio includes a wide range of products for creating, sharing and monetizing rich content, such as visual voice messaging, retail content display optimization and performance analytics on any product set.

We continue to innovate and evolve our business to respond to industry trends and maximize opportunities in emerging markets, such as digital lifestyle services and online safety, “Big Data” analytics, automotive telematics, and the consumer IoT marketplace. The key to our longevity, however, is not simply technological innovation, but our never-ending focus on understanding our customers’ needs and delivering value.

Revenues generated from our sales to Sprint and, subsequent to its April 2020 merger with Sprint, the combined T-Mobile, and their respective affiliates in the Wireless business segment accounted for 76% and 83% of the Company’s total revenues for the three months ended September 30, 2020 and 2019, respectively, and 85% and 81% for the nine months ended September 30, 2020 and 2019, respectively. T-Mobile comprised 70% and Sprint comprised 80% of our accounts receivable as of September 30, 2020 and 2019, respectively.

In future quarters, we expect our SafePath platform revenue to be negatively impacted by Sprint store closures due to COVID-19 and by the reduced number of marketing initiatives sponsored by Sprint as its integration with T-Mobile continues. We also expect to increase research and development expenses in the next few quarters, which will accelerate the buildout of additional features and functionality in the SafePath platform. This acceleration is needed to meet prospective customers’ specifications and timelines. There is no guarantee that we will be awarded contracts with prospective customers; however, we feel this investment is needed to best position the Company for these new customer opportunities.

Results of Operations

The table below sets forth certain statements of operations and comprehensive loss data expressed as a percentage of revenues for the three and nine months ended September 30, 2020 and 2019. Our historical results are not necessarily indicative of the operating results that may be expected in the future.

| | <u>For the Three Months Ended September 30,</u> | | <u>For the Nine Months Ended September 30,</u> | |
|------------------------------------------|-------------------------------------------------|---------------|------------------------------------------------|---------------|
| | <u>2020</u> | <u>2019</u> | <u>2020</u> | <u>2019</u> |
| Revenues | 100.0 % | 100.0 % | 100.0 % | 100.0 % |
| Cost of revenues | 10.5 | 8.6 | 9.7 | 9.3 |
| Gross profit | 89.5 | 91.4 | 90.3 | 90.7 |
| Operating expenses: | | | | |
| Selling and marketing | 21.0 | 15.2 | 20.7 | 17.8 |
| Research and development | 43.1 | 26.0 | 35.4 | 27.3 |
| General and administrative | 23.7 | 20.3 | 25.1 | 24.2 |
| Restructuring expense | 0.1 | 0.3 | — | 0.5 |
| Total operating expenses | 87.9 | 61.8 | 81.2 | 69.8 |
| Operating income | 1.6 | 29.6 | 9.1 | 20.9 |
| Interest income, net | 0.1 | 0.7 | 0.2 | 0.4 |
| Gain on sale of software product | — | — | — | 1.6 |
| Other expense | — | — | — | — |
| Income before provision for income taxes | 1.7 | 30.3 | 9.3 | 22.9 |
| Provision for income tax expense | 0.4 | 0.0 | 0.1 | 0.0 |
| Net income | <u>1.3 %</u> | <u>30.3 %</u> | <u>9.2 %</u> | <u>22.9 %</u> |

Three Months Ended September 30, 2020 Compared to the Three Months Ended September 30, 2019

Revenues. Revenues were \$12.6 million and \$11.8 million for the three months ended September 30, 2020 and 2019, respectively, representing an increase of \$0.8 million, or 7%. Wireless revenue of \$12.5 million increased \$0.9 million, or 8%, primarily due to increased subscribers and resulting revenues from our largest customer, T-Mobile (formerly Sprint), associated with growth in the SafePath product and also included revenue related to the newly acquired Circle operator business. Graphics revenue decreased by \$48 thousand, or 29%, over last year primarily due to lower demand as a result of reduced strategic focus and marketing efforts for this business unit.

Cost of revenues. Cost of revenues were \$1.3 million and \$1.0 million for the three months ended September 30, 2020 and 2019, respectively.

Gross profit. Gross profit was \$11.3 million, or 90% of revenues, for the three months ended September 30, 2020, compared to \$10.8 million, or 91% of revenues, for the three months ended September 30, 2019. This increase in gross profit was due to higher revenues coupled with stable variable costs during the quarter.

Selling and marketing. Selling and marketing expenses were \$2.7 million and \$1.8 million for the three months ended September 30, 2020 and 2019, respectively. This increase was primarily due to additional headcount-related expenses and increased intangibles amortization related to the Circle acquisition. The amortization of intangible assets in selling and marketing expense was \$475 thousand and \$88 thousand for the three months ended September 30, 2020 and 2019, respectively.

Research and development. Research and development expenses were \$5.4 million and \$3.1 million for the three months ended September 30, 2020 and 2019, respectively. This increase was primarily due to additional headcount related expenses and external contract development costs to support SafePath development, as well as increased intangibles amortization related to the Circle acquisition. The amortization of intangible assets in research and development expense was \$366 thousand and \$152 thousand for the three months ended September 30, 2020 and 2019, respectively.

General and administrative. General and administrative expenses were \$3.0 million and \$2.4 million for the three months ended September 30, 2020 and 2019, respectively. This increase was primarily due to an increase in non-cash stock compensation.

Nine Months Ended September 30, 2020 Compared to the Nine Months Ended September 30, 2019

Revenues. Revenues were \$38.9 million and \$31.1 million for the nine months ended September 30, 2020 and 2019, respectively, representing an increase of \$7.8 million, or 25%. Wireless revenue of \$38.4 million increased \$8.0 million, or 26%, primarily due to increased subscribers and resulting revenues from our largest customer, T-Mobile (formerly Sprint), associated with growth in the SafePath product and also included revenue related to the newly acquired Circle operator business. Graphics revenue decreased by \$187 thousand, or 29%, over last year primarily due to lower demand as a result of reduced strategic focus and marketing efforts for this business unit.

Cost of revenues. Cost of revenues were \$3.8 million and \$2.9 million for the nine months ended September 30, 2020 and 2019, respectively.

Gross profit. Gross profit was \$35.1 million, or 90% of revenues, for the nine months ended September 30, 2020, compared to \$28.2 million, or 91% of revenues, for the nine months ended September 30, 2019. This increase in gross profit was due to higher revenues coupled with stable variable costs during the quarter.

Selling and marketing. Selling and marketing expenses were \$8.0 million and \$5.5 million for the nine months ended September 30, 2020 and 2019, respectively. This increase was primarily due to additional headcount-related expenses and increased intangibles amortization related to the Circle acquisition. The amortization of intangible assets in selling and marketing expense was \$1.2 million and \$295 thousand for the nine months ended September 30, 2020 and 2019, respectively.

Research and development. Research and development expenses were \$13.8 million and \$8.5 million for the nine months ended September 30, 2020 and 2019, respectively. This increase was primarily due to additional headcount related expenses and external contract development costs to support SafePath development, as well as increased intangibles amortization related to the Circle acquisition. The amortization of intangible assets in research and development expense was \$1.0 million and \$410 thousand for the nine months ended September 30, 2020 and 2019, respectively.

General and administrative. General and administrative expenses were \$9.8 million and \$7.5 million for the nine months ended September 30, 2020 and 2019, respectively. This increase was primarily due to an increase in non-cash stock compensation and expenses related to the Circle acquisition.

Liquidity and Capital Resources

At September 30, 2020, we had \$25.9 million in cash and cash equivalents and \$29.2 million of working capital.

Operating activities

Net cash provided by operating activities was \$8.3 million for the nine months ended September 30, 2020. The primary sources of operating cash were income from operations of \$3.6 million, an add-back of non-cash expenses totaling \$5.7 million, a decrease in accounts receivable of \$1.2 million, and an increase in deferred revenue of \$0.2 million. The primary uses of operating cash were an increase in prepaid expenses and other assets of \$0.5 million and a decrease in accounts payable and accrued expenses of \$1.8 million.

Net cash used in operating activities was \$4.8 million for the nine months ended September 30, 2019. The primary uses of operating cash were an increase in accounts receivable of \$4.0 million, a decrease in prepaid expenses and other assets of \$52 thousand, a decrease in accounts payable and accrued expenses of \$0.7 million, and a decrease in deferred revenue of \$0.2 million. This usage was partially offset by an add-back of non-cash expenses totaling \$2.6 million.

Investing activities

Net cash used in investing activities was \$14.9 million for the nine months ended September 30, 2020, relating primarily to a \$13.5 million net cash payment for the Circle operator business acquisition and \$1.2 million of capital expenditures.

Net cash used in investing activities was \$4.4 million for the nine months ended September 30, 2019, relating to a \$4.0 million net cash payment for the Smart Retail (now ViewSpot) acquisition, proceeds of \$0.4 million from the sale of the Poser 3D animation software product, and \$0.8 million of capital expenditures.

Financing activities

Net cash provided by financing activities was \$4.2 million for the nine months ended September 30, 2020, reflecting proceeds from the exercise of common stock warrants.

Net cash used in financing activities was \$11.3 million for the nine months ended September 30, 2019, relating primarily to \$11.4 million from proceeds from the exercise of common stock warrants and \$119 thousand in payments of dividends on preferred stock.

Off-Balance Sheet Arrangements

We do not have any off-balance sheet arrangements.

During our normal course of business, we have made certain indemnities, commitments, and guarantees under which we may be required to make payments in relation to certain transactions. These include: intellectual property indemnities to our customers and licensees in connection with the use, sale and/or license of our products; indemnities to various lessors in connection with facility leases for certain claims arising from such facility or lease; indemnities to vendors and service providers pertaining to claims based on negligence or willful misconduct; indemnities involving the accuracy of representations and warranties in certain contracts; and indemnities to directors and officers of the Company to the maximum extent permitted under the laws of the State of Delaware. We may also issue a guarantee in the form of a standby letter of credit as security for contingent liabilities under certain customer contracts. The duration of these indemnities, commitments and guarantees varies, and in certain cases, may be indefinite. The majority of these indemnities, commitments, and guarantees may not provide for any limitation of the maximum potential for future payments we could be obligated to make. We have not recorded any liability for these indemnities, commitments, and guarantees in the accompanying consolidated balance sheets. There were no material changes in our contractual obligations and other commercial commitments that would require an update to the disclosure provided in our 2019 Annual Report on Form 10-K, filed with the SEC on March 13, 2020 ("Annual Report").

Recent Accounting Guidance

See Note 2 of our Notes to the Consolidated Financial Statements for information regarding our recent accounting guidance.

Critical Accounting Policies and Estimates

Our discussion and analysis of results of operations, financial condition, and liquidity are based upon our consolidated financial statements, which have been prepared in accordance with U.S. GAAP. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. We base our estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances. Actual results may materially differ from these estimates under different assumptions or conditions. On an on-going basis, we review our estimates to ensure that they appropriately reflect changes in our business or new information as it becomes available. See Note 2 of our Notes to the Consolidated Financial Statements for information regarding our critical accounting policies and estimates.

Item 4. Controls and Procedures

Evaluation of disclosure controls and procedures

We conducted an evaluation under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Rules 13a-15(e) under the Securities Exchange Act of 1934 (“Exchange Act”)) as of September 30, 2020. Based upon that evaluation, our Chief Executive Officer and Chief Financial Officer have determined that as of September 30, 2020, our disclosure controls and procedures were effective to ensure that the information required to be disclosed in our Exchange Act reports is recorded, processed, summarized, and reported within the time periods specified in the Securities and Exchange Commission’s rules and forms and that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure. In designing and evaluating the disclosure controls and procedures, our management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives and our management necessarily is required to apply its judgment in evaluating the cost-benefit relationship of possible controls and procedures.

Management’s responsibility for financial statements

Our management is responsible for the integrity and objectivity of all information presented in this Report. The consolidated financial statements were prepared in conformity with U.S. GAAP and include amounts based on management’s best estimates and judgments. Management believes the consolidated financial statements fairly reflect the form and substance of transactions and that the financial statements fairly represent the Company’s financial position and results of operations for the periods and as of the dates stated therein.

The Audit Committee of the Company’s Board of Directors, which is composed solely of independent directors, meets regularly with our independent registered public accounting firm, SingerLewak LLP, and representatives of management to review accounting, financial reporting, internal control, and audit matters, as well as the nature and extent of the audit effort. The Audit Committee is responsible for the engagement of the independent auditors. The independent auditors have free access to the Audit Committee.

Changes in internal control over financial reporting

There have been no changes in our internal controls over financial reporting during the quarter ended September 30, 2020 that have materially affected, or are reasonably likely to materially affect, our internal controls over financial reporting.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

The Company may become involved in various legal proceedings arising from its business activities. While management does not believe the ultimate disposition of these matters will have a material adverse impact on the Company's consolidated results of operations, cash flows, or financial position, litigation is inherently unpredictable, and depending on the nature and timing of these proceedings, an unfavorable resolution could materially affect the Company's future consolidated results of operations, cash flows or financial position in a particular period.

Item 1A. Risk Factors

In addition to the other information included in this Report, you should carefully consider the factors discussed in Part I, Item 1A. "Risk Factors" in our Annual Report, and the factors identified at the beginning of Part I, Item 2 of this Report, under the heading, "Management's Discussion and Analysis of Financial Condition and Results of Operations," which could materially affect our business, financial condition, cash flows, or results of operations. The risks described in the Annual Report are not the only risks facing the Company. Additional risks and uncertainties not currently known to the Company or that the Company currently considers immaterial also may materially adversely affect its business, financial condition, and/or operating results. There have been no material changes to the risk factors included in our Annual Report for the year ended December 31, 2019, other than as described below.

We derive a significant portion of our revenues from sales to a concentrated number of clients, and a reduction in sales to any of them may adversely impact our revenues and operating results.

In our Wireless business segment, we sell primarily to large wireless carriers, cable operators, and OEMs, so there are a limited number of actual and potential customers for our products, resulting in significant customer concentration. For the year ended December 31, 2019, sales to T-Mobile (formerly Sprint) and its affiliates comprised 84% of our total revenues.

Because of our relatively high customer concentration, a small number of significant customers possess a relative level of pricing and negotiating power over us, enabling them to achieve advantageous pricing and other contractual terms, including the ability to terminate their agreements with us with a limited amount of notice. Any material decrease in our sales to any of these customers would materially affect our revenue and profitability.

On April 1, 2020, Sprint Corporation and T-Mobile (US), Inc. ("T-Mobile") completed their previously announced merger transaction, with the combined company continuing to operate as T-Mobile. In the event that the combined company does not elect to continue using the solutions that we currently deliver, or that our sales to the combined company materially decrease as compared with our sales to Sprint pre-merger, our revenues and profitability would be materially and adversely affected. In addition and in connection with the Sprint/T-Mobile merger, on July 1, 2020, the combined company divested certain assets to DISH Network Corporation, including Sprint's Boost Mobile pre-paid wireless services business ("Boost"). A portion of our solutions sales to Sprint/T-Mobile has included sales to Boost. In the event that the divested business does not elect to continue using the solutions that we currently deliver to it, or that our sales to the divested business materially decrease as compared with our sales for Boost pre-divestiture, our revenues and profitability may be materially and adversely affected.

If there are delays in the distribution of our products or if customer negotiations for our new products cannot occur on a timely basis, we may not be able to generate revenues sufficient to meet the needs of the business in the foreseeable future or at all.

Our results of operations and financial condition may be adversely affected by public health epidemics, including the ongoing COVID-19 global health pandemic.

On March 11, 2020, the World Health Organization declared the global outbreak of COVID-19 to be a pandemic. The COVID-19 pandemic has significantly impacted economic activity and markets around the world. The circumstances relating to the pandemic are complex and evolving, with a broad number of governmental and commercial efforts to contain the spread of the virus globally. We have implemented a number of measures in an effort to protect our employees' health and well-being, including having office workers work remotely, suspending employee travel, and withdrawing from certain industry events. The duration and extent of the impact of the coronavirus pandemic on our business, operations and financial results depends on factors that cannot be accurately predicted at this time, such as the severity and transmission rate of the virus, the extent and effectiveness of containment actions, the impact on economic activity, including the possibility of recession or financial market instability, and the impact of these and other factors on our employees, customers, industry partners, and suppliers.

In the event of illnesses to key employees or a significant portion of our workforce resulting from COVID-19, we may experience inefficiencies, delays, and/or disruptions in research and development activities and increased costs resulting from our efforts to mitigate the impact of COVID-19, all of which may adversely affect our business, operations and financial results.

Additionally, government reaction to the pandemic and restrictions and limitations applied by the government as a result, continued widespread growth in infections, travel restrictions, quarantines, or other business and industry closures as a result of the pandemic could, among other things, impact the ability of our employees and contractors to perform their duties, cause increased technology and security risk due to extended and company-wide telecommuting, lead to disruptions with our suppliers, hamper our ability to integrate recent technology acquisitions and cause disruption in our relationship with our customers or prospective customers. Many of our customers and suppliers have temporarily modified their business operations as a result of the coronavirus pandemic and government reaction. Our customers may experience decreased demand for the value-added products and services that we provide to them and may seek to suspend or delay existing or new initiatives involving our products and services. A decrease in demand for our products and services or the suspension or delay of existing or new initiatives by our customers could materially adversely affect our business, financial condition, and results of operations.

To the extent the pandemic adversely affects our business and financial results, it may also have the effect of heightening many of the other risks set forth in Item 1A “Risk Factors” in our Annual Report and those additional risks set forth above.

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

The table set forth below shows all repurchases of securities by us during the three months ended September 30, 2020:

| ISSUER PURCHASES OF EQUITY SECURITIES | | | | |
|---------------------------------------|---------------------------------------------|----------------------------------------|---------------------------------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------------------------|
| Period | Total Number of Shares (or Units) Purchased | Average Price Paid per Share (or Unit) | Total Number of Shares (or Units) Purchased as Part of Publicly Announced Plans or Programs | Maximum Number (or Approximate Dollar Value) of Shares (or Units) that May Yet Be Purchased Under the Plans or Programs |
| July 1 - 31, 2020 | 22,178 | \$ 3.95 | — | — |
| August 1 - 31, 2020 | 21,997 | 3.81 | — | — |
| September 1 - 30, 2020 | 21,995 | 3.79 | — | — |
| Total | 66,170 (1) | \$ 3.85 | | |

- (1) Shares of stock repurchased by the Company as payment of withholding taxes in connection with the vesting of restricted stock awards during the applicable period. All of the shares were cancelled when they were acquired by the Company.

Item 6. Exhibits

| Exhibit | Description |
|---------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| 31.1 | Certification of Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 |
| 31.2 | Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 |
| 32.1 | Certification Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 |
| 101.INS | Inline XBRL Instance Document - the instance document does not appear in the Interactive Data File because its Inline XBRL tags are embedded within the Inline XBRL document |
| 101.SCH | Inline XBRL Taxonomy Extension Schema Document |
| 101.CAL | Inline XBRL Taxonomy Extension Calculation Linkbase Document |
| 101.DEF | Inline XBRL Taxonomy Extension Definition Linkbase Document |
| 101.LAB | Inline XBRL Taxonomy Extension Label Linkbase Document |
| 101.PRE | Inline XBRL Taxonomy Extension Presentation Linkbase Document |
| 104 | Cover Page Interactive Data File (formatted as inline XBRL and contained in Exhibit 101) |

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.

SMITH MICRO SOFTWARE, INC.

November 9, 2020

By /s/ William W. Smith, Jr.

William W. Smith, Jr.
Chairman of the Board, President and Chief Executive Officer
(*Principal Executive Officer*)

November 9, 2020

By /s/ Timothy C. Huffmyer

Timothy C. Huffmyer
Vice President and Chief Financial Officer
(*Principal Financial and Accounting Officer*)