

EVOLVING SYSTEMS INC

Form 10-Q

November 12, 2013

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**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

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**FORM 10-Q**

**x Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**

**For the quarterly period ended September 30, 2013**

**OR**

**o 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: 0-24081**

**EVOLVING SYSTEMS, INC.**

(Exact name of registrant as specified in its charter)

**Delaware**

**84-1010843**

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(State or other jurisdiction of incorporation or organization)

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

**9777 Pyramid Court, Suite 100 Englewood, Colorado**  
(Address of principal executive offices)

**80112**  
(Zip Code)

**(303) 802-1000**

(Registrant's telephone number, including area code)

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 ☐

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

Large accelerated filer ☐

Accelerated filer ☐

Non-accelerated filer ☐  
(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 ☒

As of November 6, 2013 there were 11,492,920 shares outstanding of Registrant's Common Stock (par value \$0.001 per share).

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**EVOLVING SYSTEMS, INC.**

**Quarterly Report on Form 10-Q**

**September 30, 2013**

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(in thousands except share data)

(unaudited)

|                                                                                                                                                                              | September 30,<br>2013 | December 31,<br>2012 |
|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-----------------------|----------------------|
| <b>ASSETS</b>                                                                                                                                                                |                       |                      |
| Current assets:                                                                                                                                                              |                       |                      |
| Cash and cash equivalents                                                                                                                                                    | \$ 13,719             | \$ 8,844             |
| Short-term restricted cash                                                                                                                                                   |                       | 53                   |
| Contract receivables, net of allowance for doubtful accounts of \$70 at September 30, 2013 and December 31, 2012, respectively                                               | 5,490                 | 4,803                |
| Unbilled work-in-progress, net of allowance of \$311 and \$295 at September 30, 2013 and December 31, 2012, respectively                                                     | 2,190                 | 4,802                |
| Prepaid and other current assets                                                                                                                                             | 903                   | 1,133                |
| Total current assets                                                                                                                                                         | 22,302                | 19,635               |
| Property and equipment, net                                                                                                                                                  | 285                   | 211                  |
| Amortizable intangible assets, net                                                                                                                                           |                       | 204                  |
| Goodwill                                                                                                                                                                     | 16,484                | 16,510               |
| Long-term deferred income taxes                                                                                                                                              |                       | 27                   |
| Other long-term assets                                                                                                                                                       | 1                     | 6                    |
| Total assets                                                                                                                                                                 | \$ 39,072             | \$ 36,593            |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>                                                                                                                                  |                       |                      |
| Current liabilities:                                                                                                                                                         |                       |                      |
| Current portion of capital lease obligations                                                                                                                                 | \$ 4                  | \$ 4                 |
| Accounts payable and accrued liabilities                                                                                                                                     | 3,588                 | 3,833                |
| Income taxes payable                                                                                                                                                         | 475                   | 308                  |
| Unearned revenue                                                                                                                                                             | 3,236                 | 1,596                |
| Total current liabilities                                                                                                                                                    | 7,303                 | 5,741                |
| Long-term liabilities:                                                                                                                                                       |                       |                      |
| Capital lease obligations, net of current portion                                                                                                                            | 12                    | 16                   |
| Deferred income taxes                                                                                                                                                        | 224                   |                      |
| Total liabilities                                                                                                                                                            | 7,539                 | 5,757                |
| Commitments and contingencies                                                                                                                                                |                       |                      |
| Stockholders' equity:                                                                                                                                                        |                       |                      |
| Preferred stock, \$0.001 par value; 2,000,000 shares authorized; no shares issued and outstanding as of September 30, 2013 and December 31, 2012                             |                       |                      |
| Common stock, \$0.001 par value; 40,000,000 shares authorized; 11,655,644 shares issued and 11,476,755 outstanding as of September 30, 2013 and 11,566,109 shares issued and | 12                    | 11                   |

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|                                                                                       |           |    |          |
|---------------------------------------------------------------------------------------|-----------|----|----------|
| 11,387,220 outstanding as of December 31, 2012                                        |           |    |          |
| Additional paid-in capital                                                            | 92,893    |    | 91,957   |
| Treasury stock 178,889 shares as of September 30, 2013 and December 31, 2012, at cost | (1,253)   |    | (1,253)  |
| Accumulated other comprehensive loss                                                  | (3,566)   |    | (3,297)  |
| Accumulated deficit                                                                   | (56,553)  |    | (56,582) |
| Total stockholders' equity                                                            | 31,533    |    | 30,836   |
| Total liabilities and stockholders' equity                                            | \$ 39,072 | \$ | 36,593   |

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

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## EVOLVING SYSTEMS, INC.

## CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(in thousands except per share data)

(unaudited)

|                                                                             | For the Three Months Ended September 30, |          | For the Nine Months Ended September 30, |           |
|-----------------------------------------------------------------------------|------------------------------------------|----------|-----------------------------------------|-----------|
|                                                                             | 2013                                     | 2012     | 2013                                    | 2012      |
| <b>REVENUE</b>                                                              |                                          |          |                                         |           |
| License fees and services                                                   | \$ 3,828                                 | \$ 4,741 | \$ 11,853                               | \$ 13,032 |
| Customer support                                                            | 2,241                                    | 2,093    | 6,670                                   | 6,364     |
| Total revenue                                                               | 6,069                                    | 6,834    | 18,523                                  | 19,396    |
| <b>COSTS OF REVENUE AND OPERATING EXPENSES</b>                              |                                          |          |                                         |           |
| Costs of license fees and services, excluding depreciation and amortization | 1,217                                    | 1,707    | 4,054                                   | 5,049     |
| Costs of customer support, excluding depreciation and amortization          | 378                                      | 391      | 1,087                                   | 1,138     |
| Sales and marketing                                                         | 1,230                                    | 1,270    | 3,776                                   | 3,834     |
| General and administrative                                                  | 1,017                                    | 937      | 2,680                                   | 2,844     |
| Product development                                                         | 719                                      | 675      | 2,116                                   | 2,182     |
| Depreciation                                                                | 43                                       | 72       | 117                                     | 224       |
| Amortization                                                                |                                          | 100      | 195                                     | 299       |
| Total costs of revenue and operating expenses                               | 4,604                                    | 5,152    | 14,025                                  | 15,570    |
| Income from operations                                                      | 1,465                                    | 1,682    | 4,498                                   | 3,826     |
| Other income (expense)                                                      |                                          |          |                                         |           |
| Interest income                                                             | 2                                        | 6        | 8                                       | 56        |
| Interest income, related party                                              |                                          |          |                                         | 532       |
| Interest expense                                                            | (4)                                      |          | (15)                                    | (1)       |
| Gain on sale of investments                                                 |                                          |          |                                         | 891       |
| Foreign currency exchange gain (loss)                                       | (107)                                    | (116)    | 38                                      | (166)     |
| Other income (expense), net                                                 | (109)                                    | (110)    | 31                                      | 1,312     |
| Income from operations before income taxes                                  | 1,356                                    | 1,572    | 4,529                                   | 5,138     |
| Income tax expense                                                          | 436                                      | 334      | 1,527                                   | 1,012     |
| Net income                                                                  | \$ 920                                   | \$ 1,238 | \$ 3,002                                | \$ 4,126  |
| Basic income per common share                                               | \$ 0.08                                  | \$ 0.11  | \$ 0.26                                 | \$ 0.37   |
| Diluted income per common share                                             | \$ 0.08                                  | \$ 0.11  | \$ 0.26                                 | \$ 0.36   |
| Cash dividend declared per common share                                     | \$ 0.10                                  | \$ 0.05  | \$ 0.26                                 | \$ 1.80   |
| Weighted average basic shares outstanding                                   | 11,461                                   | 11,318   | 11,431                                  | 11,248    |
| Weighted average diluted shares outstanding                                 | 11,770                                   | 11,590   | 11,717                                  | 11,490    |

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

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|                                                                                                 | <b>For the Three Months Ended September 30,</b> |             | <b>For the Nine Months Ended September 30,</b> |             |
|-------------------------------------------------------------------------------------------------|-------------------------------------------------|-------------|------------------------------------------------|-------------|
|                                                                                                 | <b>2013</b>                                     | <b>2012</b> | <b>2013</b>                                    | <b>2012</b> |
| <b>Net income</b>                                                                               | \$ 920                                          | \$ 1,238    | \$ 3,002                                       | \$ 4,126    |
| <b>Other comprehensive income (loss):</b>                                                       |                                                 |             |                                                |             |
| Foreign currency translation gain (loss)                                                        | 1,167                                           | 1,314       | (269)                                          | 1,413       |
| Unrealized gains on available-for-sale securities Unrealized holding gain arising during period |                                                 |             |                                                | 453         |
| Other comprehensive income (loss), before tax                                                   | 1,167                                           | 1,314       | (269)                                          | 1,866       |
| Income tax expense related to components of other comprehensive income (loss)                   |                                                 |             |                                                | (169)       |
| Other comprehensive income (loss), net of tax                                                   | 1,167                                           | 1,314       | (269)                                          | 1,697       |
| <b>Comprehensive income</b>                                                                     | \$ 2,087                                        | \$ 2,552    | \$ 2,733                                       | \$ 5,823    |

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

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## EVOLVING SYSTEMS, INC.

## CONDENSED CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY

(in thousands, except share data)

(unaudited)

|                                                                           | Common Stock<br>Shares | Common Stock<br>Amount | Additional<br>Paid-in<br>Capital | Treasury<br>Stock | Accumulated<br>Other<br>Comprehensive<br>Loss | Accumulated<br>(Deficit) | Total<br>Stockholders<br>Equity |
|---------------------------------------------------------------------------|------------------------|------------------------|----------------------------------|-------------------|-----------------------------------------------|--------------------------|---------------------------------|
| <b>Balance at December 31, 2012</b>                                       | <b>11,387,220</b>      | <b>\$ 11</b>           | <b>\$ 91,957</b>                 | <b>\$ (1,253)</b> | <b>\$ (3,297)</b>                             | <b>\$ (56,582)</b>       | <b>\$ 30,836</b>                |
| Stock option exercises                                                    | 75,424                 | 1                      | 299                              |                   |                                               |                          | 300                             |
| Common Stock issued pursuant to<br>to the Employee Stock<br>Purchase Plan | 1,236                  |                        | 6                                |                   |                                               |                          | 6                               |
| Stock-based compensation expense                                          |                        |                        | 228                              |                   |                                               |                          | 228                             |
| Excess tax benefits from<br>stock-based compensation                      |                        |                        | 403                              |                   |                                               |                          | 403                             |
| Restricted stock issuance, net of<br>cancellations                        | 12,875                 |                        |                                  |                   |                                               |                          |                                 |
| Common stock cash dividends                                               |                        |                        |                                  |                   |                                               | (2,973)                  | (2,973)                         |
| Net income                                                                |                        |                        |                                  |                   |                                               | 3,002                    | 3,002                           |
| Foreign currency translation<br>adjustment                                |                        |                        |                                  |                   | (269)                                         |                          | (269)                           |
| <b>Balance at September 30, 2013</b>                                      | <b>11,476,755</b>      | <b>\$ 12</b>           | <b>\$ 92,893</b>                 | <b>\$ (1,253)</b> | <b>\$ (3,566)</b>                             | <b>\$ (56,553)</b>       | <b>\$ 31,533</b>                |

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

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**EVOLVING SYSTEMS, INC.**
**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**

(in thousands)

(unaudited)

|                                                                                   | For the Nine Months Ended September 30, |           |
|-----------------------------------------------------------------------------------|-----------------------------------------|-----------|
|                                                                                   | 2013                                    | 2012      |
| <b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>                                      |                                         |           |
| Net income                                                                        | \$ 3,002                                | \$ 4,126  |
| Adjustments to reconcile net income to net cash provided by operating activities: |                                         |           |
| Depreciation                                                                      | 117                                     | 224       |
| Amortization of intangible assets                                                 | 195                                     | 299       |
| Amortization of debt issuance costs                                               | 14                                      |           |
| Stock based compensation                                                          | 228                                     | 205       |
| Accretion of discount on marketable securities                                    |                                         | (6)       |
| Gain on sale of marketable securities                                             |                                         | (891)     |
| Unrealized foreign currency transaction (gains) and losses, net                   | (38)                                    | 166       |
| Provision for bad debt                                                            |                                         | 314       |
| Provision for deferred income taxes                                               | 234                                     | 364       |
| Change in operating assets and liabilities:                                       |                                         |           |
| Contract receivables                                                              | (799)                                   | (420)     |
| Unbilled work-in-progress                                                         | 2,578                                   | (2,545)   |
| Prepaid and other assets                                                          | 180                                     | 577       |
| Accounts payable and accrued liabilities                                          | (40)                                    | (19)      |
| Unearned revenue                                                                  | 1,586                                   | (753)     |
| Net cash provided by operating activities                                         | 7,257                                   | 1,641     |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>                                      |                                         |           |
| Purchase of property and equipment                                                | (207)                                   | (64)      |
| Proceeds from sale of marketable securities, related party                        |                                         | 17,831    |
| Restricted cash                                                                   | 53                                      |           |
| Net cash (used in) provided by investing activities                               | (154)                                   | 17,767    |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>                                      |                                         |           |
| Capital lease payments                                                            | (3)                                     | (12)      |
| Common stock cash dividends                                                       | (2,973)                                 | (41,999)  |
| Excess tax benefits from stock-based compensation                                 | 403                                     |           |
| Proceeds from the issuance of stock                                               | 305                                     | 439       |
| Net cash used in financing activities                                             | (2,268)                                 | (41,572)  |
| Effect of exchange rate changes on cash                                           | 40                                      | 265       |
| Net increase (decrease) in cash and cash equivalents                              | 4,875                                   | (21,899)  |
| Cash and cash equivalents at beginning of period                                  | 8,844                                   | 34,290    |
| Cash and cash equivalents at end of period                                        | \$ 13,719                               | \$ 12,391 |
| Supplemental disclosure of cash and non-cash financing transactions:              |                                         |           |
| Interest paid                                                                     | \$                                      | \$ 1      |
| Income taxes paid                                                                 | 129                                     | 695       |
| Common stock dividend declared                                                    |                                         | 566       |

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

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**EVOLVING SYSTEMS, INC.**

**NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**NOTE 1 BASIS OF PRESENTATION**

**Organization** We are a provider of software solutions and services to the wireless, wireline and cable markets. We maintain long-standing relationships with many of the largest network operators worldwide. Our customers rely on us to develop, deploy, enhance, maintain and integrate complex, highly reliable software solutions for a range of Operations Support Systems ( OSS ). We offer software products and solutions focused on activation and provisioning: our service activation solution, *Tertio*® ( TSA ) used to activate complex bundles of voice, video and data services for traditional and next generation wireless and wireline networks; our SIM card activation solution, *Dynamic SIM Allocation TM* ( DSA ) used to dynamically allocate and assign resources to wireless devices that rely on SIM cards, and our connected devices activation solution, *Intelligent M2M Controller TM* ( IMC ) which supports the activation of M2M devices with intermittent or infrequent usage patterns.

**Interim Consolidated Financial Statements** The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America ( GAAP ) and in conformity with the instructions to Form 10-Q and Rule 8-03 of Regulation S-X and the related rules and regulations of the Securities and Exchange Commission ( SEC ). Accordingly, certain information and note disclosures normally included in financial statements prepared in accordance with GAAP have been condensed or omitted pursuant to such rules and regulations. However, we believe that the disclosures included in these financial statements are adequate to make the information presented not misleading. The unaudited condensed consolidated financial statements included in this document have been prepared on the same basis as the annual consolidated financial statements, and in our opinion reflect all adjustments, which include normal recurring adjustments necessary for a fair presentation in accordance with GAAP and SEC regulations for interim financial statements. The results for the three and nine months ended September 30, 2013 are not necessarily indicative of the results that we will have for any subsequent period. These unaudited condensed consolidated financial statements should be read in conjunction with the audited consolidated financial statements and the notes to those statements for the year ended December 31, 2012 included in our Annual Report on Form 10-K.

**Use of Estimates** The preparation of financial statements in conformity with GAAP requires us to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities, at the date of the financial statements, as well as the reported amounts of revenue and expenses during the reporting period. We made estimates with respect to revenue recognition for estimated hours to complete projects accounted for using the percentage-of-completion method, allowance for doubtful accounts, income tax valuation allowance, fair values of long-lived assets, valuation of intangible assets and goodwill, useful lives for property, equipment and intangible assets, business combinations, capitalization of internal software development costs and fair value of stock-based compensation amounts. Actual results could differ from these estimates.

**Foreign Currency** Our functional currency is the U.S. dollar. The functional currency of our foreign operations is the respective local currency for each foreign subsidiary. Assets and liabilities of foreign operations denominated in local currencies are translated at the spot rate in effect at the applicable reporting date. Our consolidated statements of operations are translated at the weighted average rate of exchange during the applicable period. The resulting unrealized cumulative translation adjustment is recorded as a component of accumulated other comprehensive income (loss) in stockholders' equity. Realized and unrealized transaction gains and losses generated by transactions denominated in a currency different from the functional currency of the applicable entity are recorded in other income (loss) in the consolidated statements of operations in the period in which they occur.

**Principles of Consolidation** The consolidated financial statements include the accounts of Evolving Systems, Inc. and subsidiaries, all of which are wholly owned. All significant intercompany transactions and balances have been eliminated in consolidation.

**Goodwill** Goodwill is the excess of acquisition cost of an acquired entity over the fair value of the identifiable net assets acquired. Goodwill is not amortized, but tested for impairment annually or whenever indicators of impairment exist. These indicators may include a significant change in the business climate, legal factors, operating performance indicators, competition, sale or disposition of a significant portion of the business or other factors. Application of the goodwill impairment test requires judgment, including the identification of reporting units, assignment of assets and liabilities to reporting units, assignment of goodwill to reporting units, and determination of the fair value of each reporting unit.

**Intangible Assets** Amortizable intangible assets consist primarily of purchased software and licenses, customer contracts and relationships, trademarks and tradenames, and business partnerships acquired in conjunction with our purchase of Tertio Telecoms Ltd. (Evolving Systems U.K.). These assets are amortized using the straight-line method over their estimated lives.

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We assess the impairment of identifiable intangibles if events or changes in circumstances indicate that the carrying value of the asset may not be recoverable. If we determine that the carrying value of intangibles and/or long-lived assets may not be recoverable, we compare the estimated undiscounted cash flows expected to result from the use of the asset and its eventual disposition to the asset's carrying amount. If an amortizable intangible or long-lived asset is not deemed to be recoverable, we recognize an impairment loss representing the excess of the asset's carrying value over its estimated fair value.

**Fair Value Measurements** Fair value is the price that would be received from selling an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Fair value is estimated by applying the following hierarchy, which prioritizes the inputs used to measure fair value into three levels and bases the categorization within the hierarchy upon the lowest level of input that is available and significant to the fair value measurement:

*Level 1* Quoted prices in active markets for identical assets or liabilities.

*Level 2* Observable inputs other than quoted prices in active markets for identical assets and liabilities, quoted prices for identical or similar assets or liabilities in inactive markets, or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities.

*Level 3* Inputs that are generally unobservable and typically reflect management's estimate of assumptions that market participants would use in pricing the asset or liability.

**Cash, Cash Equivalents and Marketable Securities** All highly liquid investments with maturities of three months or less at the date of purchase are classified as cash equivalents. Unrealized gains and losses related to changes in the fair value of securities are recognized in the accumulated other comprehensive income, net of tax in our condensed consolidated balance sheets. Changes in the fair value of available-for-sale securities impact our net income only when such securities are sold or an other-than-temporary impairment is recognized. Realized gains and losses on the sale of securities are determined by specific identification of each security's cost basis. We review our marketable debt securities to determine if the securities are other-than-temporarily impaired, which would require us to record an impairment charge in the period any such determination is made. Management determines the appropriate classification of its investments at the time of purchase and re-evaluates the available-for-sale designations as of each balance sheet date.

**Revenue Recognition** We recognize revenue when an agreement is signed, the fee is fixed or determinable and collectability is reasonably assured. We recognize revenue from two primary sources: license fees and services, and customer support. The majority of our license fees and services revenue is generated from fixed-price contracts, which provide for licenses to our software products and services to customize such software to meet our customers' use. When the customization services are determined to be essential to the functionality of the delivered software, we recognize revenue using the percentage-of-completion method of accounting. In these types of arrangements, we do not typically have Vendor Specific Objective Evidence (VSOE) of fair value on the license fee/services portion (services are related to customizing the software) of the arrangement due to the large amount of customization required by our customers; however, we do have VSOE for the warranty/maintenance services based on the renewal rate of the first year of maintenance in the arrangement. The license/services portion is recognized using the percentage-of-completion method of accounting and the warranty/maintenance services are separated based on the renewal rate in the contract and recognized ratably over the warranty or maintenance period. We estimate the percentage-of-completion for each contract based on the ratio of direct labor hours incurred to total estimated direct labor hours and recognize revenue based on the percent complete multiplied by the contract amount allocated to the license fee/services. Since estimated direct labor hours, and changes thereto, can have a

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significant impact on revenue recognition, these estimates are critical and we review them regularly. If the arrangement includes a customer acceptance provision, the hours to complete the acceptance testing are included in the total estimated direct labor hours; therefore, the related revenue is recognized as the acceptance testing is performed. Revenue is not recognized in full until the customer has provided proof of acceptance on the arrangement. Generally, our contracts are accounted for individually. However, when certain criteria are met, it may be necessary to account for two or more contracts as one to reflect the substance of the group of contracts. We record amounts billed in advance of services being performed as unearned revenue. Unbilled work-in-progress represents revenue earned but not yet billable under the terms of the fixed-price contracts. All such amounts are expected to be billed and collected within 12 months.

We may encounter budget and schedule changes or increases on fixed-price contracts caused by increased labor or overhead costs. We make adjustments to cost estimates in the period in which the facts requiring such revisions become known. We record estimated losses, if any, in the period in which current estimates of total contract revenue and contract costs indicate a loss. If revisions to cost estimates are obtained after the balance sheet date but before the issuance of the interim or annual financial statements, we make adjustments to the interim or annual financial statements accordingly.

In arrangements where the services are not essential to the functionality of the delivered software, we recognize license revenue when a license agreement has been signed, delivery and acceptance have occurred, the fee is fixed or determinable and

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collectability is reasonably assured. Where applicable, we unbundle and record as revenue fees from multiple element arrangements as the elements are delivered to the extent that VSOE of fair value of the undelivered elements exist. If VSOE for the undelivered elements does not exist, we defer fees from such arrangements until the earlier of the date that VSOE does exist on the undelivered elements or all of the elements have been delivered.

We recognize revenue from fixed-price service contracts using the proportional performance method of accounting, which is similar to the percentage-of-completion method described above. We recognize revenue from professional services provided pursuant to time-and-materials based contracts and training services as the services are performed, as that is when our obligation to our customers under such arrangements is fulfilled.

We recognize customer support, including maintenance revenue, ratably over the service contract period. When maintenance is bundled with the original license fee arrangement, its fair value, based upon VSOE, is deferred and recognized during the periods when services are provided.

**Stock-based Compensation** We account for stock-based compensation by applying a fair-value-based measurement method to account for share-based payment transactions with employees and directors. We record compensation costs associated with the vesting of unvested options on a straight-line basis over the vesting period. Stock-based compensation is a non-cash expense because we settle these obligations by issuing shares of our common stock instead of settling such obligations with cash payments. We use the Black-Scholes model to estimate the fair value of each option grant on the date of grant. This model requires the use of estimates for expected term of the options and expected volatility of the price of our common stock.

**Comprehensive Income** Comprehensive income consists of two components, net income and other comprehensive income. Other comprehensive income refers to revenue, expenses, gains, and losses that under GAAP are recorded as an element of shareholders' equity but are excluded from net income. Other comprehensive income consists of foreign currency translation adjustments from those subsidiaries not using the U.S. dollar as their functional currency and unrealized gains and losses on marketable securities categorized as available-for-sale.

**Income Taxes** We record deferred tax assets and liabilities for the estimated future tax effects of temporary differences between the tax bases of assets and liabilities and amounts reported in the accompanying condensed consolidated balance sheets, as well as operating loss and tax credit carry-forwards. We measure deferred tax assets and liabilities using enacted tax rates expected to be applied to taxable income in the years in which those temporary differences are expected to be recovered or settled. We reduce deferred tax assets by a valuation allowance if, based on available evidence, it is more likely than not that these benefits will not be realized.

We use a recognition threshold and a measurement attribute for the financial statement recognition and measurement of tax positions taken or expected to be taken in a tax return. For those benefits to be recognized, a tax position must be more likely than not to be sustained upon examination by taxing authorities.

**Recent Accounting Pronouncements** In February 2013, the FASB issued Accounting Standards Update (ASU) 2013-02, Comprehensive Income (Topic 220), Deferral of the Effective Date for Amendments to the Presentation of Reclassifications of Items Out of Accumulated Other Comprehensive Income in ASU 2012-03, to cross-reference to other disclosures currently required under U.S. GAAP for other reclassification items (that are not required under U.S. GAAP) to be reclassified directly to net income in their entirety in the same reporting period. This would

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be the case when a portion of the amount reclassified out of accumulated other comprehensive income is initially transferred to a balance sheet account (e.g., inventory for pension-related amounts) instead of directly to income or expense. We adopted ASU 2013-02 effective March 2013. The adoption of this standard did not affect our financial position or results of operations.

In July 2013, the FASB issued ASU 2013-11 regarding ASC Topic 740 Income Tax. This ASU clarifies the guidance on the presentation of an unrecognized tax benefit, or a portion of an unrecognized tax benefit, in the financial statements as a reduction to a deferred tax asset for a net operating loss carryforward, a similar tax loss, or a tax credit carryforward. This ASU will be effective for our fiscal year beginning January 1, 2014. Early adoption is permitted. We do not expect the adoption of this standard to affect our financial position or results of operations.

### **NOTE 2 GOODWILL AND INTANGIBLE ASSETS**

Changes in the carrying amount of goodwill by reporting unit were as follows (in thousands):

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|                                                           |    | License and<br>Services<br>UK |    | Customer<br>Support<br>UK |    | Total<br>Goodwill |
|-----------------------------------------------------------|----|-------------------------------|----|---------------------------|----|-------------------|
| Balance as of December 31, 2012                           | \$ | 7,385                         | \$ | 9,125                     | \$ | 16,510            |
| Effects of changes in foreign currency exchange rates (1) |    | (12)                          |    | (14)                      |    | (26)              |
| Balance at September 30, 2013                             | \$ | 7,373                         | \$ | 9,111                     | \$ | 16,484            |

(1) Represent primarily the impact of foreign currency translation for instances when goodwill is recorded in foreign entities whose functional currency is also their local currency. Goodwill balances are translated into U.S. dollars using exchange rates in effect at period end. Adjustments related to foreign currency translation are included in other comprehensive income.

We conducted our annual goodwill impairment test as of July 31, 2013, and we determined that goodwill was not impaired as of the test date. From July 31, 2013 through the date of this report, no events have occurred that we believe may have impaired goodwill.

We amortized identifiable intangible assets on a straight-line basis over their estimated lives ranging from one to seven years and include the cumulative effects of foreign currency exchange rates. As of September 30, 2013 and December 31, 2012, identifiable intangibles were as follows (in thousands):

|                           | September 30, 2013     |                             |                           | December 31, 2012      |                             |                           | Weighted-Average       |
|---------------------------|------------------------|-----------------------------|---------------------------|------------------------|-----------------------------|---------------------------|------------------------|
|                           | (1)<br>Gross<br>Amount | Accumulated<br>Amortization | Net<br>Carrying<br>Amount | (1)<br>Gross<br>Amount | Accumulated<br>Amortization | Net<br>Carrying<br>Amount | Amortization<br>Period |
| Purchased software        | \$ 1,437               | \$ 1,437                    | \$                        | \$ 1,440               | \$ 1,440                    | \$                        | 4.6 yrs                |
| Trademarks and tradenames | 724                    | 724                         |                           | 726                    | 674                         | 52                        | 7.0 yrs                |
| Business partnerships     | 118                    | 118                         |                           | 118                    | 118                         |                           | 5.0 yrs                |
| Customer relationships    | 2,122                  | 2,122                       |                           | 2,125                  | 1,973                       | 152                       | 5.3 yrs                |
|                           | \$ 4,401               | \$ 4,401                    | \$                        | \$ 4,409               | \$ 4,205                    | \$ 204                    | 5.2 yrs                |

(1) Changes in intangible gross values as of September 30, 2013 compared to December 31, 2012 are the direct result of the changes in foreign currency exchange rates for the periods then ended. Adjustments related to foreign currency translation are included in other comprehensive income.

Amortization expense of identifiable intangible assets was \$0 and \$0.1 million for the three months ended September 30, 2013 and 2012 and \$0.2 million and \$0.3 million for nine months ended September 30, 2013 and 2012. Identifiable intangible assets are fully amortized as of June 30, 2013.

## NOTE 3 EARNINGS PER COMMON SHARE

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We compute basic earnings per share ( EPS ) by dividing net income or loss available to common stockholders by the weighted average number of shares outstanding during the period, including common stock issuable under participating securities. We compute diluted EPS using the weighted average number of shares outstanding, including participating securities, plus all potentially dilutive common stock equivalents. Common stock equivalents consist of stock options.

Our policy is to treat unvested share-based payment awards that contain non-forfeitable rights to dividends or dividend equivalents, whether paid or unpaid, as participating securities, included in the computation of both basic and diluted earnings per share. The following is the reconciliation of the denominator of the basic and diluted EPS computations (in thousands, except per share data):

|                                             | For the Three Months Ended<br>September 30, |          | For the Nine Months Ended<br>September 30, |          |
|---------------------------------------------|---------------------------------------------|----------|--------------------------------------------|----------|
|                                             | 2013                                        | 2012     | 2013                                       | 2012     |
| Basic income per share:                     |                                             |          |                                            |          |
| Net income available to common stockholders | \$ 920                                      | \$ 1,238 | \$ 3,002                                   | \$ 4,126 |
| Basic weighted average shares outstanding   | 11,461                                      | 11,318   | 11,431                                     | 11,248   |
| Basic income per share:                     | \$ 0.08                                     | \$ 0.11  | \$ 0.26                                    | \$ 0.37  |
| Diluted income per share:                   |                                             |          |                                            |          |
| Net income available to common stockholders | \$ 920                                      | \$ 1,238 | \$ 3,002                                   | \$ 4,126 |
| Weighted average shares outstanding         | 11,461                                      | 11,318   | 11,431                                     | 11,248   |
| Effect of dilutive securities - options     | 309                                         | 272      | 286                                        | 242      |
| Diluted weighted average shares outstanding | 11,770                                      | 11,590   | 11,717                                     | 11,490   |
| Diluted income per share:                   | \$ 0.08                                     | \$ 0.11  | \$ 0.26                                    | \$ 0.36  |

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For the three months ended September 30, 2013 and 2012, 0.1 million and 0.1 million shares, respectively, of common stock were excluded from the dilutive stock calculation because their exercise prices were greater than the average fair value of our common stock for the period.

For the nine months ended September 30, 2013 and 2012, 0.1 million and 0.2 million shares, respectively of common stock were excluded from the dilutive stock calculation because their exercise prices were greater than the average fair value of our common stock for the period.

**NOTE 4 SHARE-BASED COMPENSATION**

We account for stock-based compensation by applying a fair-value-based measurement method to account for share-based payment transactions with employees and directors, and record compensation cost for all stock awards granted after January 1, 2006 and awards modified, repurchased, or cancelled after that date, using the modified prospective method. We record compensation costs associated with the vesting of unvested options on a straight-line basis over the vesting period. We recognized \$0.1 million of compensation expense in the consolidated statements of operations, with respect to our stock-based compensation plans for the three months ended September 30, 2013 and 2012 and \$0.2 million for the nine months ended September 30, 2013 and 2012. The following table summarizes stock-based compensation expenses recorded in the consolidated statement of operations (in thousands):

|                                                                            | For the Three Months Ended<br>September 30, |       | For the Nine Months Ended<br>September 30, |        |
|----------------------------------------------------------------------------|---------------------------------------------|-------|--------------------------------------------|--------|
|                                                                            | 2013                                        | 2012  | 2013                                       | 2012   |
| Cost of license fees and services, excluding depreciation and amortization | \$ 7                                        | \$ 5  | \$ 21                                      | \$ 14  |
| Cost of customer support, excluding depreciation and amortization          | 2                                           | 1     | 4                                          | 3      |
| Sales and marketing                                                        | 6                                           | 6     | 17                                         | 18     |
| General and administrative                                                 | 53                                          | 50    | 169                                        | 155    |
| Product development                                                        | 6                                           | 4     | 17                                         | 15     |
| Total share based compensation                                             | \$ 74                                       | \$ 66 | \$ 228                                     | \$ 205 |

**Stock Incentive Plans**

In January 1996, our stockholders approved an Amended and Restated Stock Option Plan (the "Option Plan"). Under the Option Plan, as amended, 4,175,000 shares were reserved for issuance. Options issued under the Option Plan were at the discretion of the Board of Directors, including the vesting provisions of each stock option granted. Options were granted with an exercise price equal to the closing price of our common stock on the date of grant, generally vest over four years and expire no more than ten years from the date of grant. The Option Plan terminated on January 18, 2006; options granted before that date were not affected by the plan termination. At September 30, 2013 and December 31, 2012, 0.2 and 0.3 million options remained outstanding under the Option Plan, respectively.

In June 2007, our stockholders approved the 2007 Stock Incentive Plan (the "2007 Stock Plan") with a maximum of 1,000,000 shares reserved for issuance. In June 2010, our stockholders approved an amendment to the 2007 Stock Plan which increased the maximum shares that may be awarded under the plan to 1,250,000. In June 2013, our stockholders approved an amendment to the 2007 Stock Plan which increased the maximum shares that may be awarded under the plan to 1,500,000. Awards permitted under the 2007 Stock Plan include: Stock Options, Stock

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Appreciation Rights, Restricted Stock, Restricted Stock Units, Performance Awards and Other Stock-Based Awards. Awards issued under the 2007 Stock Plan are at the discretion of the Board of Directors. As applicable, awards are granted with an exercise price equal to the closing price of our common stock on the date of grant, generally vest over four years for employees and one year for directors and expire no more than ten years from the date of grant. At September 30, 2013, there were approximately 0.3 million shares available for grant under the 2007 Stock Plan, as amended. At September 30, 2013 and December 31, 2012, 0.4 million options were issued and outstanding under the 2007 Stock Plan as amended, respectively.

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During the three months ended September 30, 2013 and 2012, there were no grants of restricted stock to members of our Board of Directors or senior management. During the three months ended September 30, 2013 and 2012, 6,000 and 2,000 shares of restricted stock vested, respectively. During the nine months ended September 30, 2013 and 2012, 19,000 and 7,000 shares of restricted stock vested, respectively. No shares of restricted stock were forfeited during the three months ended September 30, 2013 and 2012. Approximately 1,250 and 2,000 shares of restricted stock were forfeited during the nine months ended September 30, 2013 and 2012, respectively. The fair market value of restricted shares for share-based compensation expensing is equal to the closing price of our common stock on the date of grant. Stock-based compensation expense includes \$46,000 and \$8,000 for the three months ended September 30, 2013 and 2012, respectively, and \$0.1 million and \$46,000 for the nine months ended September 30, 2013 and 2012, respectively, of expense related to restricted stock grants. The restrictions on the stock awards are released quarterly, generally over four years for senior management and over one year for board members.

The fair value of each option grant is estimated on the date of grant using the Black-Scholes model. The Black-Scholes model uses four assumptions to calculate the fair value of each option grant. The expected term of share options granted is derived using the simplified method, which we adopted in January 2008. The risk-free interest rate is based upon the rate currently available on zero-coupon U.S. Treasury instruments with a remaining term equal to the expected term of the stock options. The expected volatility is based upon historical volatility of our common stock over a period equal to the expected term of the stock options. The expected dividend yield is based upon historical and anticipated payment of dividends. The weighted-average assumptions used in the fair value calculations are as follows:

|                         | For the Three Months Ended September 30, |      | For the Nine Months Ended September 30, |        |
|-------------------------|------------------------------------------|------|-----------------------------------------|--------|
|                         | 2013                                     | 2012 | 2013                                    | 2012   |
| Expected term (years)   | 9.1                                      | *    | 6.4                                     | 5.7    |
| Risk-free interest rate | 1.38%                                    | *    | 1.00%                                   | 0.83%  |
| Expected volatility     | 58.63%                                   | *    | 60.58%                                  | 65.24% |
| Expected dividend yield | 5.19%                                    | *    | 3.77%                                   | 3.53%  |

\* - None granted

The following is a summary of stock option activity under the plans for the nine months ended September 30, 2013:

|                                           | Number of<br>Shares<br>(in thousands) | Weighted-<br>Average<br>Exercise<br>Price | Weighted-<br>Average<br>Remaining<br>Contractual<br>Term<br>(Years) | Aggregate<br>Intrinsic<br>Value<br>(in thousands) |
|-------------------------------------------|---------------------------------------|-------------------------------------------|---------------------------------------------------------------------|---------------------------------------------------|
| Options outstanding at December 31, 2012  | 704                                   | \$ 4.86                                   | 4.60                                                                | \$ 1,757                                          |
| Options granted                           | 52                                    | \$ 6.62                                   |                                                                     |                                                   |
| Less options forfeited                    | (27)                                  | \$ 17.59                                  |                                                                     |                                                   |
| Less options exercised                    | (73)                                  | \$ 4.13                                   |                                                                     |                                                   |
| Options outstanding at September 30, 2013 | 656                                   | \$ 4.55                                   | 4.38                                                                | \$ 3,691                                          |
| Options exercisable at September 30, 2013 | 579                                   | \$ 4.43                                   | 3.81                                                                | \$ 3,371                                          |

There were 5,000 and 0 stock options granted during the three months ended September 30, 2013 and 2012. The weighted-average grant-date fair value of stock options granted during the three months ended September 30, 2013 was \$2.68. As of September 30, 2013, there was approximately \$0.2 million of total unrecognized compensation costs related to unvested stock options. These costs are expected to be

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recognized over a weighted average period of 2.0 years. The total fair value of stock options vested during the three months ended September 30, 2013 and 2012 was approximately \$30,000 and \$0.1 million, respectively. The total fair value of stock options vested during the nine months ended September 30, 2013 and 2012 was approximately \$0.1 million and \$0.2 million, respectively.

The deferred income tax benefits from stock option expense related to Evolving Systems U.K. totaled approximately \$4,000 and \$3,000 for the three months ended September 30, 2013 and 2012. The deferred income tax benefits from stock option expense

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related to Evolving Systems U.K. totaled approximately \$12,000 and \$11,000 for the nine months ended September 30, 2013 and 2012.

Cash received from stock option exercises for the three months ended September 30, 2013 and 2012 was \$0.2 million and \$0.1 million, respectively. Cash received from stock option exercises for the nine months ended September 30, 2013 and 2012 was \$0.3 million and \$0.4 million, respectively.

**Employee Stock Purchase Plan**

Under the Employee Stock Purchase Plan ( ESPP ), we are authorized to issue up to 550,000 shares. Employees may elect to have up to 15% of their gross compensation withheld through payroll deduction to purchase our common stock, capped at \$25,000 annually and no more than 10,000 shares per offering period. The purchase price of the stock is 85% of the lower of the market price at the beginning or end of each three-month participation period. As of September 30, 2013, there were approximately 70,000 shares available for purchase. For the three months ended September 30, 2013 and 2012, we recorded compensation expense of \$700 and \$600, respectively, and \$2,000 and \$1,000, for the nine months ended September 30, 2013 and 2012, respectively, associated with grants under the ESPP which includes the fair value of the look-back feature of each grant as well as the 15% discount on the purchase price. This expense fluctuates each period primarily based on the level of employee participation.

The fair value of each purchase made under our ESPP is estimated on the date of purchase using the Black-Scholes model. The Black-Scholes model uses four assumptions to calculate the fair value of each purchase. The expected term of each purchase is based upon the three-month participation period of each offering. The risk-free interest rate is based upon the rate currently available on zero-coupon U.S. Treasury instruments with a remaining term equal to the expected term of each offering. The expected volatility is based upon historical volatility of our common stock. The expected dividend yield is based upon historical and anticipated payment of dividends. The weighted average assumptions used in the fair value calculations are as follows:

|                         | For the Three Months Ended September 30, |        | For the Nine Months Ended September 30, |        |
|-------------------------|------------------------------------------|--------|-----------------------------------------|--------|
|                         | 2013                                     | 2012   | 2013                                    | 2012   |
| Expected term (years)   | 0.25                                     | 0.25   | 0.25                                    | 0.25   |
| Risk-free interest rate | 0.02%                                    | 0.10%  | 0.05%                                   | 0.09%  |
| Expected volatility     | 42.99%                                   | 45.30% | 44.62%                                  | 41.40% |
| Expected dividend yield | 3.75%                                    | 3.30%  | 4.04%                                   | 3.50%  |

Cash received from employee stock plan purchases for the three months ended September 30, 2013 and 2012 was \$2,000. Cash received from employee stock plan purchases for the nine months ended September 30, 2013 and 2012 was \$6,000 and \$5,000, respectively.

We issued shares related to the ESPP of approximately 300 and 400 for the three months ended September 30, 2013 and 2012, respectively. We issued shares related to the ESPP of approximately 1,200 and 1,000 for the nine months ended September 30, 2013 and 2012, respectively.

**NOTE 5 CONCENTRATION OF CREDIT RISK**

For the three months ended September 30, 2013, one significant customer (defined as contributing at least 10%) accounted for 15% of revenue from operations. The significant customer for the three months ended September 30, 2013 is a large telecommunications operator in Europe. For the three months ended September 30, 2012, two significant customers accounted for 33% (19% and 14%), of revenue from operations. The significant customers for the three months ended September 30, 2012 are large telecommunications operators in Europe and Mexico. For the nine months ended September 30, 2013, one significant customer accounted for 11% of revenue from operations. This customer is a large telecommunications operator in the Europe. For the nine months ended September 30, 2012, three significant customers accounted for 40% (15%, 15% and 10%) of revenue from operations. These customers are large telecommunications operators in the Commonwealth of Independent States, Europe and Mexico.

As of September 30, 2013, four significant customers accounted for approximately 49% (16%, 12%, 11% and 10%) of contract receivables and unbilled work-in-progress. These customers are large telecommunication operators in Europe, South America, Asia and Africa. At December 31, 2012, three significant customers accounted for approximately 46% (21%, 14% and 11%) of contract receivables and unbilled work-in-progress. These customers are a large telecommunications operator in the Commonwealth of Independent States, Asia and Mexico.

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**NOTE 6 LONG-TERM DEBT**

On October 22, 2012, we entered into a \$5.0 million Loan and Security Agreement (the "Revolving Facility"). The \$5.0 million Revolving Facility bears interest at the greater of 2.75% or the U.S.A Prime Rate minus one half of one percent (0.5%). Prime Rate was 3.25% as of September 30, 2013. The Revolving Facility is secured by all assets of Evolving Systems, including a pledge, subject to certain limitations with respect to stock of foreign subsidiaries, of the stock of the existing and future direct subsidiaries of Evolving Systems. There is no mandated borrowing required against the Revolving Facility. To take an advance under the Revolving Facility, we must have a balance of \$3.0 million in cash on deposit and have quarterly net income and a specified ratio of current assets to current liabilities, as defined in the Revolving Facility. The Revolving Facility requires us to pay an annual credit facility fee of \$10,000. All accrued interest on outstanding borrowings under the Revolving Facility is paid monthly, with any outstanding balance due with a final maturity of October 22, 2014. As of September 30, 2013, we are in compliance with the covenants and have \$5.0 million available to borrow under this Revolving Facility.

**NOTE 7 INCOME TAXES**

We recorded net income tax expense of \$0.4 and \$0.3 million for the three months ended September 30, 2013 and 2012, respectively. The net expense during the three months ended September 30, 2013 consisted of current income tax expense of \$0.3 million and a deferred tax expense of \$0.1 million. The current tax expense consists primarily of income tax from our U.S., U.K. and India based operations. The deferred tax expense was primarily related to undistributed foreign earnings offset by capitalized expenses for tax purpose related to the acquisition of Telespree. The net expense during the three months ended September 30, 2012 consisted deferred tax expense of \$0.3 million. The deferred tax expense was primarily related to the utilization of Net Operating Loss ("NOL") assets net of a tax benefit due to intangible assets from our U.K.-based operations and utilization of Minimum Alternative Tax ("MAT") from our operations in India.

We recorded net income tax expense of \$1.5 million and \$1.0 million for the nine months ended September 30, 2013 and 2012, respectively. The net expense during the nine months ended September 30, 2013 consisted of current income tax expense of \$1.3 million and a deferred tax expense of \$0.2 million. The current tax expense consists primarily of income tax from our U.S., U.K. and India based operations, and unrecoverable foreign withholding taxes in the U.S. and U.K. The deferred tax expense was primarily related to undistributed foreign earnings offset by a tax benefit related to intangible assets from our U.K.-based operations and capitalized expenses for tax purpose related to the acquisition of Telespree. The net expense during the nine months ended September 30, 2012 consisted of current income tax expense of \$0.6 million and a deferred tax expense of \$0.4 million. The current tax expense consists primarily of income tax from our U.K.-based operations, income taxes related to our operations in India and Alternative Minimum Tax ("AMT"), unrecoverable foreign withholding taxes and state income taxes in the U.S. The deferred tax expense was primarily related to the decrease in deferred tax assets related to stock compensation and accrued liabilities, the utilization of NOL assets in the period and a tax benefit related to intangible assets from our U.K.-based operations and utilization of MAT assets from operations in India.

Our effective tax rate of 32% for the three months ended September 30, 2013 was increased from our effective tax rate of 21% for the three months ended September 30, 2012. The increase in our effective tax rate relates to a higher proportion of our income being generated in the U.K. and the realization of Net Operating Losses ("NOL") comprised of windfall tax benefits related to stock-based compensation in the U.S. When utilized, windfall tax benefits related to stock-based compensation are recorded as a reduction to our taxes payable when realized, with a corresponding credit to additional paid in capital, not income tax expense.

Our effective tax rate of 34% for the nine months ended September 30, 2013 was increased from our effective tax rate of 20% for the nine months ended September 30, 2012. The increase in our effective tax rate relates to a higher proportion of our income being generated in the

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U.K. and the realization of Net Operating Losses ( NOL ) comprised of windfall tax benefits related to stock-based compensation in the U.S. When utilized, windfall tax benefits related to stock-based compensation are recorded as a reduction to our taxes payable when realized, with a corresponding credit to additional paid in capital, not income tax expense.

In conjunction with the acquisition of Evolving Systems U.K., we recorded certain identifiable intangible assets. Since the amortization of these identifiable intangibles is not deductible for income tax purposes, we established a long-term deferred tax liability of \$4.6 million at the acquisition date for the expected difference between what would be expensed for financial reporting purposes and what would be deductible for income tax purposes. As of September 30, 2013 and December 31, 2012, this component of the deferred tax liability was \$0 and \$39,000, respectively. This deferred tax liability relates to Evolving Systems U.K., and has no impact on our ability to recover U.S.-based deferred tax assets. This deferred tax liability was recognized as a reduction of deferred income tax expense as the identifiable intangibles were amortized.

As of September 30, 2013 and December 31, 2012 we continued to maintain a valuation allowance on portions of our domestic net deferred tax asset. Such assets primarily consist of certain NOL carryforwards and other tax credits. The NOL are comprised of windfall tax benefits related to stock-based compensation. Unused windfall tax benefits may not be recorded as an asset

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on our Consolidated Balance Sheets but are recorded as a reduction to our taxes payable when realized, with a corresponding credit to additional paid in capital. The \$0.2 million of net deferred tax liabilities as of September 30, 2013, were comprised of the following:

|                                                     |    | September 30, 2013 |
|-----------------------------------------------------|----|--------------------|
| Deferred tax assets:                                |    |                    |
| Net operating loss carryforwards                    | \$ | 2,322              |
| Research & Development Credits                      |    | 303                |
| AMT/MAT credit                                      |    | 1,032              |
| Stock Compensation                                  |    | 574                |
| Depreciable assets                                  |    | 149                |
| Accrued liabilities and reserves                    |    | 78                 |
| Section 956 Inclusion                               |    |                    |
| Total deferred tax assets                           |    | 4,458              |
| Deferred tax liabilities                            |    |                    |
| Undistributed Foreign Earnings                      | \$ | (1,051)            |
| Total deferred tax liability                        |    | (1,051)            |
| Net deferred tax assets, before valuation allowance | \$ | 3,407              |
| Valuation allowance                                 |    | (3,631)            |
| Net deferred tax liability                          | \$ | (224)              |

As of September 30, 2013 and December 31, 2012 we had no liability for unrecognized tax benefits.

We conduct business globally and, as a result, Evolving Systems, Inc. or one or more of our subsidiaries file income tax returns in the U.S. federal jurisdiction and various state and foreign jurisdictions. In the normal course of business, we are subject to examination by taxing authorities throughout the world, namely the United Kingdom, Germany and India.

## **NOTE 8 STOCKHOLDERS EQUITY**

### **Common Stock Dividend**

On August 13, 2013, our Board of Directors declared a third quarter cash dividend of \$0.10 per share, payable September 13, 2013, to stockholders of record on August 30, 2013. Previously, our Board of Directors declared a first quarter cash dividend of \$.08 per share, payable April 12, 2013, to stockholders of record March 22, 2013 and a second quarter cash dividend of \$0.08 per share, payable July 12, 2013, to stockholders of record June 10, 2013.

Any determination to declare a future quarterly dividend, as well as the amount of any cash dividend which may be declared, will be based on our financial position, earnings, financial covenants to which we are subject, earnings outlook and other relevant factors at that time.

**Certain Anti-Takeover Provisions/Agreements with Stockholders**

Our restated certificate of incorporation allows the board of directors to issue up to 2,000,000 shares of preferred stock and to determine the price, rights, preferences and privileges of those shares without any further vote or action by our stockholders. The rights of the holders of our common stock will be subject to, and may be adversely affected by, the rights of the holders of any preferred stock that may be issued in the future. Issuance of preferred stock, while providing desired flexibility in connection with possible acquisitions and other corporate purposes, could make it more difficult for a third party to acquire a majority of our outstanding voting stock. As of September 30, 2013 and December 31, 2012, no shares of preferred stock were outstanding.

In addition, we are subject to the anti-takeover provisions of Section 203 of Delaware General Corporation Law which prohibit us from engaging in a business combination with an interested stockholder for a period of three years after the date of the transaction in which the person became an interested stockholder, unless the business combination is approved in the prescribed manner. The application of Section 203 may have the effect of delaying or preventing changes in control of our management, which could adversely affect the market price of our common stock by discouraging or preventing takeover attempts that might result in the payment of a premium price to our stockholders.

Table of Contents**NOTE 9 SEGMENT INFORMATION**

We define operating segments as components of our enterprise for which separate financial information is reviewed regularly by the chief operating decision-makers to evaluate performance and to make operating decisions. We have identified our Chief Executive Officer and Vice President of Finance as our chief operating decision-makers ( CODM ). These chief operating decision makers review revenues by segment and review overall results of operations.

We currently operate our business as two operating segments based on revenue type: license fees and services revenue, and customer support revenue (as shown on the consolidated statements of operations). License fees and services ( L&S ) revenue represents the fees received from the license of software products and those services directly related to the delivery of the licensed products, such as fees for custom development and integration services. Customer support ( CS ) revenue includes annual support fees, recurring maintenance fees, fees for maintenance upgrades and warranty services. Warranty services that are similar to software maintenance services are typically bundled with a license sale. Total assets by segment have not been disclosed as the information is not available to the chief operating decision-makers.

Segment information is as follows (in thousands):

|                                                                               | For the Three Months Ended<br>September 30, |          | For the Nine Months Ended<br>September 30, |           |
|-------------------------------------------------------------------------------|---------------------------------------------|----------|--------------------------------------------|-----------|
|                                                                               | 2013                                        | 2012     | 2013                                       | 2012      |
| <b>Revenue</b>                                                                |                                             |          |                                            |           |
| License fees and services                                                     | \$ 3,828                                    | \$ 4,741 | \$ 11,853                                  | \$ 13,032 |
| Customer support                                                              | 2,241                                       | 2,093    | 6,670                                      | 6,364     |
| Total revenue                                                                 | 6,069                                       | 6,834    | 18,523                                     | 19,396    |
| <b>Revenue less costs of revenue, excluding depreciation and amortization</b> |                                             |          |                                            |           |
| License fees and services                                                     | 2,611                                       | 3,034    | 7,799                                      | 7,983     |
| Customer support                                                              | 1,863                                       | 1,702    | 5,583                                      | 5,226     |
|                                                                               | 4,474                                       | 4,736    | 13,382                                     | 13,209    |
| <b>Unallocated Costs</b>                                                      |                                             |          |                                            |           |
| Other operating expenses                                                      | 2,966                                       | 2,882    | 8,572                                      | 8,860     |
| Depreciation and amortization                                                 | 43                                          | 172      | 312                                        | 523       |
| Interest income                                                               | (2)                                         | (6)      | (8)                                        | (56)      |
| Interest income, related party                                                |                                             |          |                                            | (532)     |
| Interest expense                                                              | 4                                           |          | 15                                         | 1         |
| Gain on sale of investments                                                   |                                             |          |                                            | (891)     |
| Foreign currency exchange (gain) loss                                         | 107                                         | 116      | (38)                                       | 166       |
| <b>Income from operations before income taxes</b>                             | \$ 1,356                                    | \$ 1,572 | \$ 4,529                                   | \$ 5,138  |

***Geographic Regions***

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We are headquartered in Englewood, a suburb of Denver, Colorado. We use customer locations as the basis for attributing revenues to individual countries. We provide products and services on a global basis through our headquarters and our London-based Evolving Systems U.K. subsidiary. Additionally, personnel in Bangalore, India provide software development services to our global operations. Financial information relating to operations by geographic region is as follows (in thousands):

| For the Three Months Ended September 30, |          |            |          |          |            |          |  |
|------------------------------------------|----------|------------|----------|----------|------------|----------|--|
|                                          | L&S      | 2013<br>CS | Total    | L&S      | 2012<br>CS | Total    |  |
| <b>Revenue</b>                           |          |            |          |          |            |          |  |
| United Kingdom                           | \$ 868   | \$ 479     | \$ 1,347 | \$ 1,245 | \$ 479     | \$ 1,724 |  |
| Other                                    | 2,960    | 1,762      | 4,722    | 3,496    | 1,614      | 5,110    |  |
| Total revenues                           | \$ 3,828 | \$ 2,241   | \$ 6,069 | \$ 4,741 | \$ 2,093   | \$ 6,834 |  |

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| For the Nine Months Ended September 30, |           |            |           |           |            |           |  |
|-----------------------------------------|-----------|------------|-----------|-----------|------------|-----------|--|
|                                         | L&S       | 2013<br>CS | Total     | L&S       | 2012<br>CS | Total     |  |
| <b>Revenue</b>                          |           |            |           |           |            |           |  |
| United Kingdom                          | \$ 2,323  | \$ 1,418   | \$ 3,741  | \$ 2,763  | \$ 1,475   | \$ 4,238  |  |
| Other                                   | 9,530     | 5,252      | 14,782    | 10,269    | 4,889      | 15,158    |  |
| Total revenues                          | \$ 11,853 | \$ 6,670   | \$ 18,523 | \$ 13,032 | \$ 6,364   | \$ 19,396 |  |

|                               | September 30,<br>2013 | December 31,<br>2012 |  |
|-------------------------------|-----------------------|----------------------|--|
| <b>Long-lived assets, net</b> |                       |                      |  |
| United States                 | \$ 32                 | \$ 47                |  |
| United Kingdom                | 16,607                | 16,842               |  |
| Other                         | 130                   | 36                   |  |
|                               | \$ 16,769             | \$ 16,925            |  |

**NOTE 10 COMMITMENTS AND CONTINGENCIES**
**(a) Other Commitments**

As permitted under Delaware law, we have agreements with officers and directors under which we agree to indemnify them for certain events or occurrences while the officer or director is, or was, serving at our request in this capacity. The term of the indemnification period is indefinite. There is no limit on the amount of future payments we could be required to make under these indemnification agreements; however, we maintain Director and Officer insurance policies, as well as an Employment Practices Liability Insurance Policy, that may enable us to recover a portion of any amounts paid. As a result of our insurance policy coverage, we believe the estimated fair value of these indemnification agreements is minimal. Accordingly, there were no liabilities recorded for these agreements as of September 30, 2013 or December 31, 2012.

We enter into standard indemnification terms with customers and suppliers, in the ordinary course of business, for third party claims arising under our contracts. In addition, as we may subcontract the development of deliverables under customer contracts, we could be required to indemnify customers for work performed by subcontractors. Depending upon the nature of the indemnification, the potential amount of future payments we could be required to make under these indemnification agreements may be unlimited. We may be able to recover damages from a subcontractor or other supplier if the indemnification results from the subcontractor's or supplier's failure to perform. To the extent we are unable to recover damages from a subcontractor or other supplier, we could be required to reimburse the indemnified party for the full amount. We have never incurred costs to defend lawsuits or settle claims relating to an indemnification. As a result, we believe the estimated fair value of these agreements is minimal. Accordingly, there were no liabilities recorded for these agreements as of September 30, 2013 or December 31, 2012.

Our standard license agreements contain product warranties that the software will be free of material defects and will operate in accordance with the stated requirements for a limited period of time. The product warranty provisions require us to cure any defects through any reasonable means. We believe the estimated fair value of the product warranty provisions in the license agreements in place with our customers is minimal. Accordingly, there were no liabilities recorded for these product warranty provisions as of September 30, 2013 or December 31, 2012.

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Our software arrangements generally include a product indemnification provision whereby we will indemnify and defend a customer in actions brought against the customer for claims that our products infringe upon a copyright, trade secret, or valid patent of a third party. We have not historically incurred any significant costs related to product indemnification claims. Accordingly, there were no liabilities recorded for these indemnification provisions as of September 30, 2013 or December 31, 2012.

### **(b)      Litigation**

We are involved in various legal matters arising in the normal course of business. Losses, including estimated costs to defend, are recorded for these matters to the extent they are probable of loss and the amount of loss can be reasonably estimated.

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**NOTE 11 RELATED PARTY TRANSACTIONS**

In connection with the restructuring of our business after the sale of the Numbering Business, we eliminated the position of Sr. Vice President and General Counsel held by Anita T. Moseley, effective July 1, 2011. We entered into a consulting agreement with Ms. Moseley to provide consulting services to the Company, on an as needed basis, through December 31, 2011, which was subsequently extended through December 31, 2013. We had obligations of \$11,000 and \$0 in the consolidated balance sheets as of September 30, 2013 and as of December 31, 2012, respectively, related to this agreement. We recorded approximately \$26,000 and \$12,000 of general and administrative expense in the consolidated statements of operations, related to this agreement, for the three months ended September 30, 2013 and 2012, respectively and \$62,000 and \$22,000 of general and administrative expense in the consolidated statements of operations, related to this agreement, for the nine months ended September 30, 2013 and 2012, respectively.

During the year ended December 31, 2011, we purchased \$16.9 million of Primus Telecommunications Group, Inc. ( PTGI ) senior secured notes, net of purchase discounts, on the open market through a registered broker dealer. The Singer Family Trust, our largest shareholder, owns approximately 22% of our outstanding common shares and approximately 14% of the outstanding shares of PTGI as of December 31, 2012. Richard Ramlall, Senior Vice President of Corporate Development and Chief Communications Officer of PTGI, serves on our board of directors but is not on our Investment Committee of the Board and as such is not involved in any of our investment decisions, nor is Mr. Ramlall involved with any oversight of the financial operations of PTGI.

During the nine months ended September 30, 2012, we recorded interest income of \$0.5 million in our Consolidated Statements of Operations related to the PTGI senior secured notes, respectively. As of April 23, 2012 the investments were sold for approximately \$17.8 million and we realized a gain on sale of approximately \$0.9 million.

**NOTE 12 SUBSEQUENT EVENTS**

On November 12, 2013, our Board of Directors declared a fourth quarter cash dividend of \$0.10 per share, payable December 13, 2013, to stockholders of record November 29, 2013.

On October 24, 2013, Evolving Systems, Inc., Topaz Merger Sub, Inc., a wholly owned subsidiary of Evolving Systems ( Merger Sub ), Telespree Communications ( Telespree ) and Gill Cogan, as representative of the shareholders and change in control payment recipients of Telespree entered into an Agreement and Plan of Merger ( Merger Agreement ). Pursuant to the terms of the Merger Agreement: (a) Merger Sub was merged with and into Telespree (the Merger ), with Telespree continuing as the surviving corporation and as a wholly owned subsidiary of Evolving Systems; and (b) Evolving Systems: (i) acquired all of the outstanding securities of Telespree; (ii) made an initial payment totaling approximately \$1.6 million comprised of approximately \$0.8 million in cash and approximately \$0.8 million in common stock (73,280 shares); (iii) agreed to make a payment on the 1 year anniversary of the Merger of \$0.5 million, with such payment being available to secure Telespree's representations and warranties under the Merger Agreement; and (iv) will potentially make payments in cash on the achievement of certain financial targets for the period from October 25, 2013 through October 24, 2016.

The number of shares of common stock issued in connection with the Merger was calculated based on a 15-day volume-weighted average price of Evolving Systems' common stock on the Nasdaq Capital Market. The shares of common stock were issued in a private placement that was

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exempt from registration under Section 4(a)(2) of the Securities Act of 1933 and Rule 506(b) of Regulation D promulgated thereunder, based upon certain representations of the Telespree shareholders.

The Company issued a press release and filed a Form 8-K with the SEC announcing the transaction on October 25, 2013.

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

#### SPECIAL NOTE ABOUT FORWARD-LOOKING STATEMENTS

*This Quarterly Report on Form 10-Q contains forward-looking statements that have been made pursuant to the provisions of the Private Securities Litigation Reform Act of 1995. These forward-looking statements are based on current expectations, estimates, and projections about Evolving Systems' industry, management's beliefs, and certain assumptions made by management. Forward-looking statements include our expectations regarding product, services, and maintenance revenue, annual savings associated with the organizational changes effected in prior years, and short- and long-term cash needs. In some cases, words such as anticipates, expects, intends, plans, believes, estimates, variations of these words, and similar expressions are intended to identify forward-looking statements. The statements are not guarantees of future performance and are subject to certain risks, uncertainties, and assumptions that are difficult to predict; therefore, actual results may differ materially from those expressed or forecasted in any forward-looking statements. Risks and uncertainties of our business include those set forth in our Annual Report on Form 10-K for*

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*the year ended December 31, 2012 under Item 1A. Risk Factors as well as additional risks described in this Form 10-Q. Unless required by law, we undertake no obligation to update publicly any forward-looking statements, whether as a result of new information, future events, or otherwise. However, readers should carefully review the risk factors set forth in other reports or documents we file from time to time with the Securities and Exchange Commission, particularly the Quarterly Reports on Form 10-Q and any Current Reports on Form 8-K.*

**OVERVIEW**

We are a provider of software solutions and services to the wireless, wireline and cable markets. We maintain long-standing relationships with many of the largest network operators worldwide. Our customers rely on us to develop, deploy, enhance, maintain and integrate complex, highly reliable software solutions for a range of OSS. We offer software products and solutions focused on activation and provisioning: our service activation solution, TSA is used to activate complex bundles of voice, video and data services for traditional and next generation wireless and wireline networks; our SIM card activation solution, DSA is used to dynamically allocate and assign resources to wireless devices that rely on SIM cards, and our connected devices activation solution, IMC supports the activation of M2M devices with intermittent or infrequent usage patterns.

We recognize revenue in accordance with the prescribed accounting standards for software revenue recognition under generally accepted accounting principles. Our license fees and services revenues fluctuate from period to period as a result of the timing of revenue recognition on existing projects.

**RECENT DEVELOPMENTS**

Consolidated revenue decreased to \$6.1 million and \$18.5 million from \$6.8 million and \$19.4 million for three and nine months ended September 30, 2013 and 2012, respectively. The decrease in revenue is due to lower license and services revenue primarily from DSA and TSA.

Our twelve month backlog decreased to \$11.4 million as of September 30, 2013, compared to \$11.6 million as of September 30, 2012.

We have operations in foreign countries where the local currency is used to prepare the financial statements which are translated into our reporting currency, U.S. Dollars. Changes in the exchange rates between these currencies and our reporting currency are partially responsible for some of the changes from period to period in our financial statement amounts. The chart below summarizes how our revenue and expenses would change had they been reported on a constant currency basis. The constant currency basis assumes that the exchange rate was constant for the periods presented (in thousands).

|                                         | For the Three Months Ended<br>September 30,<br>2013 vs. 2012 |       | For the Nine Months Ended<br>September 30,<br>2013 vs. 2012 |       |
|-----------------------------------------|--------------------------------------------------------------|-------|-------------------------------------------------------------|-------|
| Revenue                                 | \$                                                           | (3)   | \$                                                          | (21)  |
| Costs of revenue and operating expenses |                                                              | (322) |                                                             | (650) |

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|                |    |     |    |     |
|----------------|----|-----|----|-----|
| Operating Gain | \$ | 319 | \$ | 629 |
|----------------|----|-----|----|-----|

The net effect of our foreign currency translations for the three months ended September 30, 2013 was a \$3,000 decrease in revenue and a \$0.3 million decrease in operating expenses versus the three months ended September 30, 2012. The net effect of our foreign currency translations for the nine months ended September 30, 2013 was a \$21,000 decrease in revenue and a \$0.7 million decrease in operating expenses versus the nine months ended September 30, 2012.

### RESULTS OF OPERATIONS

The following table presents the unaudited consolidated statements of operations reflected as a percentage of total revenue.

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|                                                                             | For the Three Months Ended September 30, |      | For the Nine Months Ended September 30, |      |
|-----------------------------------------------------------------------------|------------------------------------------|------|-----------------------------------------|------|
|                                                                             | 2013                                     | 2012 | 2013                                    | 2012 |
| <b>REVENUE</b>                                                              |                                          |      |                                         |      |
| License fees and services                                                   | 63%                                      | 69%  | 64%                                     | 67%  |
| Customer support                                                            | 37%                                      | 31%  | 36%                                     | 33%  |
| Total revenue                                                               | 100%                                     | 100% | 100%                                    | 100% |
| <b>COSTS OF REVENUE AND OPERATING EXPENSES</b>                              |                                          |      |                                         |      |
| Costs of license fees and services, excluding depreciation and amortization | 20%                                      | 25%  | 22%                                     | 26%  |
| Costs of customer support, excluding depreciation and amortization          | 6%                                       | 6%   | 6%                                      | 6%   |
| Sales and marketing                                                         | 20%                                      | 18%  | 20%                                     | 20%  |
| General and administrative                                                  | 17%                                      | 14%  | 14%                                     | 14%  |
| Product development                                                         | 12%                                      | 10%  | 11%                                     | 11%  |
| Depreciation                                                                | 1%                                       | 1%   | 1%                                      | 1%   |
| Amortization                                                                |                                          | 1%   | 2%                                      | 2%   |
| Total costs of revenue and operating expenses                               | 76%                                      | 75%  | 76%                                     | 80%  |
| Income from operations                                                      | 24%                                      | 25%  | 24%                                     | 20%  |
| Other income (expense)                                                      |                                          |      |                                         |      |
| Interest income                                                             | 0%                                       | 0%   | 0%                                      | 0%   |
| Interest income, related party                                              |                                          |      |                                         | 3%   |
| Interest expense                                                            | (0)%                                     |      | (0)%                                    | (0)% |
| Gain on sale of investments                                                 |                                          |      |                                         | 5%   |
| Foreign currency exchange gain (loss)                                       | (2)%                                     | (2)% | 0%                                      | (1)% |
| Other income (expense), net                                                 | (2)%                                     | (2)% | 0%                                      | 7%   |
| Income from operations before income taxes                                  | 22%                                      | 23%  | 24%                                     | 27%  |
| Income tax expense                                                          | 7%                                       | 5%   | 8%                                      | 5%   |
| Net income                                                                  | 15%                                      | 18%  | 16%                                     | 22%  |

## **Revenue**

Revenue is comprised of license fees/services and customer support. License fees and services revenue represent the fees we receive from the licensing of our software products and those services directly related to the delivery of the licensed product as well as integration and consulting services. Customer support revenue includes annual support, recurring maintenance and warranty services. Warranty services consist of maintenance services and are typically bundled with a license sale and the related revenue, based on Vendor-Specific Objective Evidence ( VSOE ), is deferred and recognized ratably over the warranty period.

Revenue for the three months ended September 30, 2013 and 2012 was \$6.1 million and \$6.8 million, respectively. Revenue for the nine months ended September 30, 2013 and 2012 was \$18.5 million and \$19.4 million, respectively. Decreased revenue in the period is primarily due to decreased license and services revenue from our DSA and TSA products offset by an increase in customer support revenue from our DSA product.

***License Fees and Services***

License fees and services revenue decreased \$0.9 million, or 19%, to \$3.8 million for the three months ended September 30, 2013 from \$4.7 million for the three months ended September 30, 2012. The decrease in revenue is primarily related to lower revenue from DSA and TSA.

License fees and services revenue decreased \$1.1 million, or 9%, to \$11.9 million for the nine months ended September 30, 2013 from \$13.0 million for the nine months ended September 30, 2012. The decrease in revenue is primarily related to lower revenue from DSA and TSA.

***Customer Support***

Customer support revenue increased \$0.1 million, or 7%, to \$2.2 million for the three months ended September 30, 2013 from \$2.1 million for the three months ended September 30, 2012. The increase in customer support revenue is due to higher revenue from DSA partially offset by lower TSA customer support revenue.

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Customer support revenue increased \$0.3 million, or 5%, to \$6.7 million for the nine months ended September 30, 2012 from \$6.4 million for the nine months ended September 30, 2012. The increase in customer support revenue is due to increased revenue from DSA partially offset by lower TSA customer support revenue.

***Costs of Revenue, Excluding Depreciation and Amortization***

Costs of revenue, excluding depreciation and amortization, consist primarily of personnel costs and other direct costs associated with these personnel, facilities costs, costs of third-party software and partner commissions. Costs of revenue, excluding depreciation and amortization, were \$1.6 million and \$2.1 million for the three months ended September 30, 2013 and 2012. Costs of revenue, excluding depreciation and amortization, were \$5.1 million and \$6.2 million for the nine months ended September 30, 2013 and 2012, respectively.

***Costs of License Fees and Services, Excluding Depreciation and Amortization***

Costs of license fees and services, excluding depreciation and amortization, decreased \$0.5 million, or 29%, to \$1.2 million for the three months ended September 30, 2013 from \$1.7 million for the three months ended September 30, 2012. The decrease in costs is primarily the result of decreased third party software and partner commissions for our DSA product, lower subcontractor and decreased hours spent on license fee and services projects. As a percentage of license fees and services revenue, costs of license fees and services, excluding depreciation and amortization, decreased to 32% for the three months ended September 30, 2013 from 36% for the three months ended September 30, 2012. The decrease in costs as a percentage of revenue is primarily the result of the aforementioned decrease in expenses during the period.

Costs of license fees and services, excluding depreciation and amortization, decreased \$1.0 million, or 20%, to \$4.0 million for the nine months ended September 30, 2013 from \$5.0 million for the nine months ended September 30, 2012. The decrease in costs is primarily the result of decreased third party software and partner commissions for our DSA product. As a percentage of license fees and services revenue, costs of license fees and services, excluding depreciation and amortization, decreased to 34% for the nine months ended September 30, 2012 from 39% for the nine months ended September 30, 2012. The decrease in costs as a percentage of revenue is primarily the result of the aforementioned decrease in expenses during the period.

***Costs of Customer Support, Excluding Depreciation and Amortization***

Costs of customer support, excluding depreciation and amortization, was \$0.4 million for the three months ended September 30, 2013 and September 30, 2012. As a percentage of customer support revenue, costs of customer support revenue, excluding depreciation and amortization, decreased to 17% for the three months ended September 30, 2013 from 19% for the three months ended September 30, 2012. The decrease in costs as a percentage of revenue is primarily the result of the increased customer support revenue during the period.

Costs of customer support, excluding depreciation and amortization, was \$1.1 million for the nine months ended September 30, 2013 and September 30, 2012. As a percentage of customer support revenue, costs of customer support revenue, excluding depreciation and amortization, decreased to 16% for the nine months ended September 30, 2013 from 18% for the nine months ended September 30, 2012. The decrease in

costs as a percentage of revenue is primarily the result of the increased customer support revenue during the period.

***Sales and Marketing***

Sales and marketing expenses primarily consist of compensation costs, including incentive compensation and commissions, travel expenses, advertising, marketing and facilities expenses. Sales and marketing expenses decreased \$40,000, or 3%, to \$1.2 million for the three months ended September 30, 2013 from \$1.3 million for the three months ended September 30, 2012. The decrease in expenses is related primarily to lower travel and marketing expense. As a percentage of total revenue, sales and marketing expenses increased to 20% for the three months ended September 30, 2013 from 19% for the three months ended September 30, 2012. The increase in sales and marketing expenses as a percentage of revenue is primarily due to the decrease in revenue during the period.

Sales and marketing expenses were \$3.8 million for the nine months ended September 30, 2013 and September 30, 2012. As a percentage of total revenue, sales and marketing expenses was 20% for the nine months ended September 30, 2013 and September 30, 2012.

***General and Administrative***

General and administrative expenses consist principally of employee related costs and professional fees for the following departments: facilities, finance, legal, human resources, and certain executive management. General and administrative expenses increased \$0.1 million, or 9%, to \$1.0 million for the three months ended September 30, 2013 from \$0.9 million for the three months

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ended September 30, 2012. The increase in general and administrative expenses is primarily the result of higher professional fees relating to the Telespree acquisition. As a percentage of revenue, general and administrative expenses increased to 17% for the three months ended September 30, 2013 from 14% for the three months ended September 30, 2012. The increase in general and administrative expenses as a percentage of revenue is primarily due to the decrease in revenue during the period.

General and administrative expenses decreased \$0.1 million, or 6%, to \$2.7 million from \$2.8 million for the nine months ended September 30, 2013 and 2012, respectively. The decrease is the result of the following: while professional fees relating to the Telespree acquisition were higher for the nine month period ending September 30, 2013 as compared to the same period in 2012, there was no bad debt reserve for the nine months ended September 30, 2013 as compared to the bad debt reserve of \$0.3 million taken during the comparable period in 2012. As a percentage of total revenue, general and administrative expenses decreased to 14% for the nine months ended September 30, 2013 from 15% for the nine months ended September 30, 2012. The decrease in general and administrative expenses as a percentage of revenue is primarily due to the aforementioned decrease of the bad debt reserve during the period.

### ***Product Development***

Product development expenses consist primarily of employee related costs and subcontractor expenses. Product development expenses were \$0.7 million for the three months ended September 30, 2013 and 2012, respectively. As a percentage of revenue, product development expenses for the three months ended September 30, 2013 and 2012, increased to 12% from 10%, respectively. The increase as a percentage of revenue is primarily due to the decrease in revenue during the period.

Product development expenses decreased \$0.1 million, or 3% to \$2.1 million from \$2.2 million for the nine months ended September 30, 2013 and 2012, respectively. The decrease in costs is primarily due to decreased hours spent on research and development projects, lower employee costs offset by higher travel expense. As a percentage of revenue, product development expenses for the nine months ended September 30, 2013 and 2012, were 11%, respectively.

### ***Depreciation***

Depreciation expense consists of depreciation of long-lived property and equipment. Depreciation expense decreased \$29,000, or 40%, to \$43,000 from \$0.1 million for the three months ended September 30, 2013 and 2012, respectively. As a percentage of total revenue, depreciation expense for the three months ended September 30, 2013 and 2012, remained at 1%.

Depreciation expense decreased \$0.1 million, or 48%, to \$0.1 million from \$0.2 million for the nine months ended September 30, 2013 and 2012, respectively. As a percentage of total revenue, depreciation expense for the nine months ended September 30, 2013 and 2012, remained at 1%.

### ***Amortization***

Amortization expense consists of amortization of identifiable intangible assets acquired through our acquisition of Evolving Systems U.K. Amortization expense decreased \$0.1 million, or 100% to \$0 from \$0.1 million for the three months ended September 30, 2013 and 2012, respectively. As a percentage of total revenue, amortization expense for the three months ended September 30, 2013 decreased to 0% from 1% for the three months ended September 30, 2012.

Amortization expense decreased \$0.1 million, or 35% to \$0.2 million from \$0.3 million for the nine months ended September 30, 2013 and 2012, respectively. As a percentage of total revenue, amortization expense for the nine months ended September 30, 2013 and 2012, were 2%, respectively.

#### ***Interest Income***

Interest income includes interest income earned on cash, cash equivalents and long-term investments. Interest income decreased \$4,000 or 67%, to \$2,000 for the three months ended September 30, 2013 from \$6,000 for the three months ended September 30, 2012.

Interest income decreased \$0.6 million or 99%, to \$8,000 for the nine months ended September 30, 2013 from \$0.6 million for the nine months ended September 30, 2012. The decrease was due primarily to interest from long-term investments which were sold in the second quarter of 2012.

#### ***Interest Expense***

Interest expense includes interest expense from the amortization of debt issuance costs from our revolving debt facility and interest expense from our capital lease obligations. Interest expense was \$4,000 and \$0 for the three months ended September 30,

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2013 and 2012, respectively. The increase of \$4,000 is primarily due to the amortization of debt issuance costs related to our \$5.0 million revolving credit facility which was signed on October 22, 2012.

Interest expense was \$15,000 and \$1,000 for the nine months ended September 30, 2013 and 2012, respectively. The increase of \$14,000 is primarily due to the amortization of debt issuance costs related to our \$5.0 million revolving credit facility which was signed on October 22, 2012.

***Foreign Currency Exchange Gain (Loss)***

Foreign currency transaction gains (losses) resulted from transactions denominated in a currency other than the functional currency of the respective subsidiary and were (\$0.1) million for the three months ended September 30, 2013 and 2012, respectively, and \$38,000 and (\$0.2) million for the nine months ended September 30, 2013 and 2012, respectively. The gains (losses) were generated primarily through the re-measurement of certain non-functional currency denominated financial assets and liabilities of our Evolving Systems U.K. and India subsidiaries.

***Other Comprehensive Income (Loss)***

Other comprehensive income refers to revenue, expenses, gains, and losses that under GAAP are recorded as an element of shareholders' equity but are excluded from net income. Other comprehensive income consists of foreign currency translation adjustments from those subsidiaries not using the U.S. dollar as their functional currency and unrealized gains and losses on marketable securities categorized as available-for-sale. Other comprehensive income decreased to \$1.2 million during the three months ended September 30, 2013 compared to \$1.3 million during the three months ended September 30, 2012. The decrease is related through the re-measurement of certain non-functional currency denominated financial assets and liabilities of our Evolving Systems U.K. and India subsidiaries. For the nine months ended September 30, 2013, other comprehensive loss decreased to (\$0.3) million from \$1.7 million income for the nine months ended September 30, 2012. The decrease is related through the re-measurement of certain non-functional currency denominated financial assets and liabilities of our Evolving Systems U.K. and India subsidiaries, partially offset by the net unrealized gains related to long-term corporate debt securities in 2012.

***Income Taxes***

We recorded net income tax expense of \$0.4 and \$0.3 million for the three months ended September 30, 2013 and 2012, respectively. The net expense during the three months ended September 30, 2013 consisted of current income tax expense of \$0.3 million and a deferred tax expense of \$0.1 million. The current tax expense consists primarily of income tax from our U.S., U.K. and India based operations. The deferred tax expense was primarily related to undistributed foreign earnings offset by capitalized expenses for tax purpose related to the acquisition of Telespree. The net expense during the three months ended September 30, 2012 consisted deferred tax expense of \$0.3 million. The deferred tax expense was primarily related to the utilization of Net Operating Loss ( NOL ) assets net of a tax benefit due to intangible assets from our U.K.-based operations and utilization of Minimum Alternative Tax ( MAT ) from our operations in India.

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We recorded net income tax expense of \$1.5 million and \$1.0 million for the nine months ended September 30, 2013 and 2012, respectively. The net expense during the nine months ended September 30, 2013 consisted of current income tax expense of \$1.3 million and a deferred tax expense of \$0.2 million. The current tax expense consists primarily of income tax from our U.S., U.K. and India based operations, and unrecoverable foreign withholding taxes in the U.S. and U.K. The deferred tax expense was primarily related to undistributed foreign earnings offset by a tax benefit related to intangible assets from our U.K.-based operations and capitalized expenses for tax purpose related to the acquisition of Telespree. The net expense during the nine months ended September 30, 2012 consisted of current income tax expense of \$0.6 million and a deferred tax expense of \$0.4 million. The current tax expense consists primarily of income tax from our U.K.-based operations, income taxes related to our operations in India and Alternative Minimum Tax ( AMT ), unrecoverable foreign withholding taxes and state income taxes in the U.S. The deferred tax expense was primarily related to the decrease in deferred tax assets related to stock compensation and accrued liabilities, the utilization of NOL assets in the period and a tax benefit related to intangible assets from our U.K.-based operations and utilization of MAT assets from operations in India.

Our effective tax rate of 32% for the three months ended September 30, 2013 was increased from our effective tax rate of 21% for the three months ended September 30, 2012. The increase in our effective tax rate relates to a higher proportion of our income being generated in the U.K. and the realization of Net Operating Losses ( NOL ) comprised of windfall tax benefits related to stock-based compensation in the U.S. When utilized, windfall tax benefits related to stock-based compensation are recorded as a reduction to our taxes payable when realized, with a corresponding credit to additional paid in capital, not income tax expense.

Our effective tax rate of 34% for the nine months ended September 30, 2013 was increased from our effective tax rate of 20% for the nine months ended September 30, 2012. The increase in our effective tax rate relates to a higher proportion of our income being generated in the U.K. and the realization of Net Operating Losses ( NOL ) comprised of windfall tax benefits related to stock-

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based compensation in the U.S. When utilized, windfall tax benefits related to stock-based compensation are recorded as a reduction to our taxes payable when realized, with a corresponding credit to additional paid in capital, not income tax expense.

In conjunction with the acquisition of Evolving Systems U.K., we recorded certain identifiable intangible assets. Since the amortization of these identifiable intangibles is not deductible for income tax purposes, we established a long-term deferred tax liability of \$4.6 million at the acquisition date for the expected difference between what would be expensed for financial reporting purposes and what would be deductible for income tax purposes. As of September 30, 2013 and December 31, 2012, this component of the deferred tax liability was \$0 and \$39,000, respectively. This deferred tax liability relates to Evolving Systems U.K., and has no impact on our ability to recover U.S.-based deferred tax assets. This deferred tax liability was recognized as a reduction of deferred income tax expense as the identifiable intangibles were amortized.

As of September 30, 2013 and December 31, 2012 we continued to maintain a valuation allowance on portions of our domestic net deferred tax asset. Such assets primarily consist of certain NOL carryforwards and other tax credits. The NOL are comprised of windfall tax benefits related to stock-based compensation. Unused windfall tax benefits may not be recorded as an asset on our Consolidated Balance Sheets but are recorded as a reduction to our taxes payable when realized, with a corresponding credit to additional paid in capital. See Note 7 to the financial statements for a summary of our net deferred tax liability.

## **FINANCIAL CONDITION**

Our working capital position increased \$1.1 million to \$15.0 million as of September 30, 2013 from \$13.9 million as of December 31, 2012. The majority of the increase in working capital is related to the increase from current assets of cash and contract receivables offset by a reduction of unbilled work-in progress and an increase in current liabilities related to unearned revenue.

## **CONTRACTUAL OBLIGATIONS**

There have been no material changes to the contractual obligations as disclosed in our 2012 Annual Report on Form 10-K.

## **LIQUIDITY AND CAPITAL RESOURCES**

We have historically financed operations through cash flows from operations and equity transactions. At September 30, 2013, our principal source of liquidity was \$13.7 million in cash and cash equivalents and \$5.5 million in contract receivables, net of allowances and \$5.0 million of unused availability under our revolving credit facility.

Net cash provided by operating activities for the nine months ended September 30, 2013 and 2012 was \$7.3 million and \$1.6 million, respectively. The increase in cash provided by operating activities for the nine months ended September 30, 2013 was primarily due to a

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decrease in unbilled work-in-progress and prepaid and other assets, an increase in unearned revenue, partially offset by an increase in contract receivables and reduction of accounts payable and accrued liabilities.

Net cash (used in) provided by investing activities during each of the nine months ended September 30, 2013 and 2012 was (\$0.2) million and \$17.8 million, respectively. The decrease in cash provided by investing activities is primarily due to the sale of marketable securities in the nine months ended September 30, 2012.

Net cash used in financing activities for the nine months ended September 30, 2013 and 2012 was \$2.3 million and \$41.6 million, respectively. The decrease in cash used in financing activities is primarily due to the special \$2.00 per share common stock cash dividend paid on January 3, 2012 and the special \$1.70 per share common stock cash dividend paid on May 29, 2012.

We believe that our current cash and cash equivalents, together with anticipated cash flow from operations will be sufficient to meet our working capital, capital expenditure and financing requirements for at least the next twelve months. In making this assessment we considered the following:

- Our cash and cash equivalents balance at September 30, 2013 of \$13.7 million;
- Our working capital balance of \$15.0 million;
- Our demonstrated ability to generate positive cash flows from operations;
- The declaration of our quarterly cash dividends of \$0.08 per share for the first and second quarters of 2013, \$0.10 per share in the third quarter 2013 and the possibility of future dividends;
- Our backlog as of September 30, 2013 of approximately \$11.4 million, including \$6.0 million in license fees and services and \$5.4 million in customer support;

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- The availability under our revolving credit facility of \$5.0 million as of September 30, 2013.

We are exposed to foreign currency rate risks which impact the carrying amount of our foreign subsidiaries and our consolidated equity, as well as our consolidated cash position due to translation adjustments. For the nine months ended September 30, 2013 and 2012, the effect of exchange rate changes resulted in a \$40,000 increase and \$0.3 million increase to consolidated cash. We do not currently hedge our foreign currency exposure, but we monitor rate changes and may hedge our exposures if we see significant negative trends in exchange rates.

**OFF-BALANCE SHEET ARRANGEMENTS**

We have no off-balance sheet arrangements that have a material current effect or that are reasonably likely to have a material future effect on our financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources.

**ITEM 3. QUANTITATIVE AND QUALITATIVE MARKET RISK DISCLOSURES**

In the ordinary course of business, we are exposed to certain market risks, including changes in interest rates and foreign currency exchange rates. Uncertainties that are either non-financial or non-quantifiable such as political, economic, tax, other regulatory, or credit risks are not included in the following assessment of market risks.

***Interest Rate Risks***

Our cash balances are subject to interest rate fluctuations and as a result, interest income amounts may fluctuate from current levels.

***Market Risks***

Our exposure to market risk relates primarily to our investment portfolio. Any significant future declines in their market values could have a material adverse affect our financial condition and operating results. When evaluating the investments for other-than-temporary impairment, we review factors such as the length of time and extent to which fair value has been below cost basis, the financial condition of the issuer and any changes thereto, and our intent to sell, or whether it is more likely than not we will be required to sell the investment before recovery of the investment's amortized cost basis. Our investment policy requires investments to be rated B- or better. Marketable debt securities have been classified and accounted for as available-for-sale. Management determines the appropriate classification of its investments at the time of purchase and reevaluates the available-for-sale designations as of each balance sheet date. We classify our marketable debt securities as either short-term or long-term based on each instrument's underlying contractual maturity date. Marketable debt securities with maturities of 12 months or less are classified as short-term and marketable debt securities with maturities greater than 12 months are classified as long-term.

***Foreign Currency Risk***

We are exposed to favorable and unfavorable fluctuations of the U.S. dollar (our functional currency) against the currencies of our operating subsidiaries. Any increase (decrease) in the value of the U.S. dollar against any foreign currency that is the functional currency of one of our operating subsidiaries will cause the parent company to experience unrealized foreign currency translation losses (gains) with respect to amounts already invested in such foreign currencies. In addition, we and our operating subsidiaries are exposed to foreign currency risk to the extent that we enter into transactions denominated in currencies other than our respective functional currencies, such as accounts receivable (including intercompany amounts) that are denominated in a currency other than their own functional currency. Changes in exchange rates with respect to these items will result in unrealized (based upon period-end exchange rates) or realized foreign currency transaction gains and losses upon settlement of the transactions. In addition, we are exposed to foreign exchange rate fluctuations related to our operating subsidiaries' monetary assets and liabilities and the financial results of foreign subsidiaries and affiliates when their respective financial statements are translated into U.S. dollars for inclusion in our consolidated financial statements. Cumulative translation adjustments are recorded in accumulated other comprehensive income (loss) as a separate component of equity. As a result of foreign currency risk, we may experience economic loss and a negative impact on earnings and equity with respect to our holdings solely as a result of foreign currency exchange rate fluctuations.

The relationship between the British pound sterling, Indian rupee and the U.S. dollar, which is our functional currency, is shown below, per one U.S. dollar:

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|                        | September 30,                            |          | December 31,                            |          |
|------------------------|------------------------------------------|----------|-----------------------------------------|----------|
| Spot rates:            | 2013                                     |          | 2012                                    |          |
| British pound sterling | 0.61947                                  |          | 0.61850                                 |          |
| Indian rupee           | 63.01197                                 |          | 54.97526                                |          |
|                        |                                          |          |                                         |          |
|                        | For the Three Months Ended September 30, |          | For the Nine Months Ended September 30, |          |
| Average rates:         | 2013                                     | 2012     | 2013                                    | 2012     |
| British pound sterling | 0.64546                                  | 0.63095  | 0.64643                                 | 0.63415  |
| Indian rupee           | 62.24288                                 | 54.57977 | 57.50821                                | 52.84820 |

At the present time, we do not hedge our foreign currency exposure or use derivative financial instruments that are designed to reduce our long-term exposure to foreign currency exchange risk. To the extent that translation and transaction gain and losses become significant, we will consider various options to reduce this risk.

## ITEM 4. CONTROLS AND PROCEDURES

We maintain disclosure controls and procedures, as such term is defined in Rule 13a-15(e) under the Securities Exchange Act of 1934 (the Exchange Act), that are designed to provide reasonable assurance that information required to be disclosed by us in reports that we file or submit under the Exchange Act is recorded, processed, summarized, and reported within the time periods specified in Securities and Exchange Commission rules and forms, and that such information is accumulated and communicated to our management, including our Chief Executive Officer and Vice President Finance and Administration, as appropriate, to allow timely decisions regarding required disclosure.

Our management, including our Chief Executive Officer and Vice President Finance and Administration, has evaluated the effectiveness of our disclosure controls and procedures as of the end of the period covered by this Quarterly Report on Form 10-Q. Based on that evaluation, our Chief Executive Officer and Vice President Finance and Administration have concluded that our disclosure controls and procedures were effective as of the end of such period.

In designing and evaluating our disclosure controls and procedures, management recognized that disclosure controls and procedures, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the disclosure controls and procedures are met. Additionally, in designing disclosure controls and procedures, our management necessarily was required to apply its judgment in evaluating the cost-benefit relationship of possible disclosure controls and procedures. The design of any disclosure controls and procedures also is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions.

During the three and nine months ended September 30, 2013, there were no changes in our internal controls over financial reporting (as defined in Rule 13a-15(f) under the Exchange Act) or in other factors 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

We are involved in various legal matters arising in the normal course of business. Losses, including estimated costs to defend, are recorded for these matters to the extent they were probable of loss and the amount of loss could be reasonably estimated. We had no pending legal proceedings as of September 30, 2013.

## ITEM 1A. RISK FACTORS

There have been no material changes in the risk factors previously disclosed in our Annual Report on Form 10-K for the fiscal year ended December 31, 2012, filed with the SEC on March 12, 2013, except with respect to the following:

***Dividends*** - Our Board of Directors has declared a first and second quarter cash dividend of \$0.08 per share and a third quarter cash dividend of \$0.10 per share. The decision to pay dividends in the future will depend on general business conditions, the impact of such payment on our financial condition and other factors our Board of Directors may consider to be relevant. If we elect to pay future dividends, this could reduce our cash reserves to levels that may be inadequate to fund expansions to our business plan or unanticipated contingent liabilities.

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This Quarterly Report on Form 10-Q should be read in conjunction with the risk factors defined in our Annual Report on Form 10-K for the year ended December 31, 2012 under Item 1A. Risk Factors.

**ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS**

None

**ITEM 3. DEFAULTS UPON SENIOR SECURITIES**

None

**ITEM 4. MINE SAFETY DISCLOSURES**

None

**ITEM 5. OTHER INFORMATION**

None

**ITEM 6. EXHIBITS**

(a) Exhibits

Exhibit 31.1 Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

Exhibit 31.2 Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

Exhibit 32.1 Certification pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

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Exhibit 32.2 Certification pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

Exhibit 101 - The following financial information from the quarterly report on Form 10-Q of Evolving Systems, Inc. for the quarter ended September 30, 2013, formatted in XBRL (eXtensible Business Reporting Language): (i) Condensed Consolidated Balance Sheets, (ii) Condensed Consolidated Statements of Operations, (iii) Condensed Consolidated Statements of Comprehensive income, (iv) Condensed Consolidated Statements of Changes in Stockholders' Equity, (v) Condensed Consolidated Statements of Cash Flows, and (vi) Notes to the Condensed Consolidated Financial Statements.

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\* Pursuant to Rule 406T of Regulation S-T, the Interactive Data Files on Exhibit 101 hereto are deemed not filed or part of a registration statement or prospectus for purposes of Sections 11 or 12 of the Securities Act of 1933, as amended, are deemed not filed for purposes of Section 18 of the Securities and Exchange Act of 1934, as amended, and otherwise are not subject to liability under those sections.

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**SIGNATURE**

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.

Date: November 12, 2013

/s/ DANIEL J. MOORHEAD  
Daniel J. Moorhead  
Vice President Finance and Administration,  
Treasurer and Secretary  
(Principal Financial and Accounting Officer)