Quadrant 4 System Corp
Form 10-Q
August 15, 2016

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

FORM 10-Q

(Mark One)
QUARTERLY REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended June 30, 2016

TRANSITION REPORT UNDER SECTION 13 OR 15(d) OF THE EXCHANGE ACT
For the transition period from_________________to ___________________________

Commission File Number 33-42498
QUADRANT 4 SYSTEM CORPORATION
(Exact name of registrant as specified in its charter)

Illinois	65-0254624
(State or other jurisdiction of incorporation or organization)	(IRS Employer Identification No.)

1501 E. Woodfield Road, Suite 205 S, Schaumburg, IL 60173
(Address of principal executive offices)

(855) 995-7367
(Registrant's telephone number, including area code)

Indicate by checkmark 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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§ 229.405 of this chapter) is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-Q or any amendment to this Form 10-Q.

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

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

Indicate by checkmark whether the registrant is a shell company (as defined in Rule 126.2 of the Exchange Act). Yes No

The number of shares of common stock outstanding as of August 15, 2016 was 106,991,504.

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

QUADRANT 4 SYSTEM CORPORATION
Condensed Consolidated Balance Sheets

	June 30, 2016 (Unaudited)	December 31, 2015 (Audited)
ASSETS		
Current Assets		
Cash	$283,279	$246,492
Accounts and unbilled receivables (net of allowance for doubtful accounts of $550,000 and $550,000 at June 30, 2016 and December 31, 2015, respectively)	12,083,455	9,555,725
Inventory	35,968	95,400
Other current assets	168,889	148,076
Total current assets	12,571,591	10,045,693
Long-term assets		
Intangible assets, customer lists and technology stacks – net	9,580,373	11,566,643
Goodwill	2,004,600	2,004,600
Equipment under capital lease – net	321,091	366,961
Equipment – net	144,618	168,169
Other Long-term assets		
Software development costs – net	13,077,772	11,357,524
Deferred licensing and royalty fees – net	840,000	960,000
Other assets	342,820	327,329
TOTAL ASSETS	$38,882,865	$36,796,919
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current Liabilities		
Accounts payable and accrued expenses	$6,270,559	$5,652,257
Note payable – revolver	9,863,260	7,601,904
Earn outs payable	319,531	343,075
Current obligation under capital lease	157,199	152,640
Current maturities - long term debt (net of debt discount of $38,333 and debt issuance costs of $188,049 at June 30, 2016 and $31,945 and $223,605 at December 31, 2015, respectively)	2,248,364	2,413,739
Total current liabilities	18,858,913	16,163,615
Non-current obligation under capital lease	83,052	162,149
Long-term debt, less current maturities (net of debt discount of $12,778 and debt issuance costs of $47,127 at June 30, 2016 and $197,333 and $133,374 at December 31, 2015, respectively).	4,208,896	4,205,389
Total liabilities	23,150,861	20,531,153
Stockholders' Equity		

Common stock - $0.001 par value; authorized: 200,000,000 shares: issued and outstanding 106,991,504 and 108,861,774 shares at June 30, 2016 and December 31, 2015, respectively	106,992	108,862
Additional paid-in capital	34,822,979	35,194,180
Accumulated deficit	(19,197,967)	(19,037,276)
Total stockholders' equity	15,732,004	16,265,766
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	$38,882,865	$36,796,919

See notes to the condensed consolidated financial statements

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QUADRANT 4 SYSTEM CORPORATION
Condensed Consolidated Statements of Operations
(Unaudited)

	Three Months Ending June 30,		Six Months Ending June 30,	
	2016	2015	2016	2015
Revenue	$14,564,628	$13,069,754	$26,503,227	$26,708,400
Cost of revenue	8,544,770	7,684,286	16,363,309	16,030,599
Gross Margin	6,019,858	5,385,468	10,139,918	10,677,801
Operating expenses:				
General and administrative expenses	(3,086,134)	(3,246,518)	(6,150,915)	(6,045,858)
Research & Development	(64,249)	(469,795)	(354,826)	(1,040,023)
Amortization, impairment and depreciation expense	(1,331,594)	(1,020,357)	(2,812,981)	(2,341,616)
Reversal of assignment of legal judgment	692,000	-	692,000	-
Interest expense	(1,211,580)	(522,190)	(1,673,887)	(1,037,419)
Total	(5,001,557)	(5,258,860)	(10,300,609)	(10,464,916)
Net Income/(loss) before income taxes	1,018,301	126,608	(160,691)	212,885
Provision for Income taxes	-	-	-	-
Net Income/(loss)	$1,018,301	$126,608	$(160,691)	$212,885
Net income per common share – basic	$*	$*	$*	$*
Net income per common share – fully diluted	$*	$*	$*	$*
Weighted average common shares – basic	108,800,117	102,956,279	108,830,945	102,809,840
Weighted average common shares – fully diluted	114,291,361	107,552,461	108,830,945	107,406,023

*Less than $0.01, per share
See notes to the condensed consolidated financial statements

QUADRANT 4 SYSTEM CORPORATION
Condensed Consolidated Statements of Cash Flows
(Unaudited)

	For the Six Months Ending June 30, 2016	2015
Cash flows from operating activities:		
Net (loss)/income	$(160,691)	$212,885
Adjustments to reconcile net (loss)/income to net cash used in operating activities:		
Amortization, impairment and depreciation expense	2,812,981	2,341,616
Deferred license cost	120,000	120,000
Provision for doubtful accounts	-	56,365
Issuance of stock for services and interest	-	52,500
Issuance of warrants for services/debentures	318,929	25,823
Reversal of assignment of legal judgement	(692,000)	-
Changes in assets and liabilities, net of the effect of the acquisitions		
Accounts and unbilled receivables	(2,527,730)	(2,467,267)
Inventory	59,432	(118,596)
Other current assets	(266,119)	(190,766)
Software development costs	(2,355,288)	(3,410,568)
Deferred finance costs	121,803	121,802
Other assets	108,013	213,035
Obligation under capital lease	(74,538)	387,805
Accounts payable and accrued expenses	594,760	1,680,729
Net cash used in operating activities	(1,940,448)	(974,637)
Cash flows from investing activities:		
Purchase of equipment	(449)	(467,812)
Acquisition of assets (net of assets assumed of $104,700, notes payable assumed of $1,000,000, contingent payments of $400,000 and issuance of common stock of $142,500)	-	(469,728)
Net cash used in investing activities	(449)	(937,540)
Cash flows from financing activities:		
Borrowings on revolver	26,444,121	23,413,786
Repayments of revolver	(24,182,765)	(23,027,040)
Payments of long-term debt	(283,672)	(125,404)
Net cash provided by/(used in) financing activities	1,977,684	261,342
Net increase/(decrease) in cash	36,787	(1,650,835)
Cash - beginning of period	246,492	2,285,557
Cash - end of period	$283,279	$634,722
Supplemental disclosure of noncash information		
Cash paid for:		
Interest	$1,014,747	$466,980
Income Taxes	$-	$-

Supplemental disclosure for Investing activities:		
Equity issued for acquisition of assets	$-	$142,500

See notes to the condensed consolidated financial statements

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QUADRANT 4 SYSTEM CORPORATION
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

NOTE 1 – ORGANIZATION AND OPERATIONS

Organization

Quadrant 4 System Corporation (sometimes referred to herein as “Quadrant 4,” “Company,” “we” or “us”) was incorporated by the Florida Department of State on May 9, 1990 as Sun Express Group, Inc. and changed its name on March 31, 2011. The Company changed its domicile to Illinois on April 25, 2013. The Company generates revenue from clients located mostly in North America operating out of multiple office locations in the United States. In addition, the Company’s revenues are derived from a few select industries pertaining to information technology, consulting, professional services and vertical cloud platforms that include a large number of participants and are subject to rapid change.

Operations

The Company is engaged in the information technology sector as a provider of Software-as-a-Service (SaaS) systems to the health insurance (through our QBIX/QHIX/QWEX™ offering), media (through our QBLITZ™ offering) and education (through our QEDX™ offering) verticals (collectively, the “Platforms”). Along with the Platforms, we also provide core services that leverage on our proprietary Social Media, Mobility, Analytics and Cloud (SMAC) technology “stack” (a set of software subsystems or components needed to create a complete Platform). These services include Consulting, Application Life Cycle Management, Enterprise Applications & Data Management, Mobility Applications and Business Analytics (collectively, “Consulting”). We blend our Consulting services with our Platforms to offer client-specific and industry-specific solutions to the healthcare, media, education, retail and manufacturing industry segments (collectively, “Solutions”). Consulting and Solutions are referred to together as “Services”.

The Company generates revenues principally from two broad segments, namely Services and Platforms. The Services segment includes Consulting, which we bill on a time and materials basis; Solutions, which we bill on time and materials basis; and managed services, which we bill under fixed monthly fees for pre-determined services. The Platform segment bills on transaction basis such as per member per month enrolled for the QBIX/QHIX/QWEX Platform; per bandwidth consumed for the QBLITZ Platform; and per student per month for the QEDX Platform. The QHIX revenue stream started in 2016 and the QBIX revenue stream started in 2015. The Company expects to increase its Platform-based revenues during the second half of 2016.

NOTE 2 – BASIS OF PRESENTATION

The accompanying unaudited condensed consolidated financial statements and related notes have been prepared in accordance with United States generally accepted accounting principles (“GAAP”) and with the applicable rules and regulations of the Securities and Exchange Commission (SEC). Accordingly, they do not include all of the information and footnotes required by GAAP for complete financial statements presentation. In the opinion of the management, all adjustments (consisting of normal recurring accruals) considered necessary to present fairly the financial position, results of operations and cash flows for interim financial statements have been included. This form 10-Q should be read in conjunction with the Company’s Annual Report on Form 10-K for the year ended December 31, 2015 (the “2015 Form 10-K”). Interim results are not necessarily indicative of the results for the fiscal year ending December 31, 2016.

Consolidated Financial Statements

The accompanying consolidated financial statements have been prepared in accordance with GAAP and include all the accounts of the Company. As of January 1, 2016, DialedIn Corporation, a wholly owned subsidiary of the Company, has been merged with and into the Company. All intercompany transactions for 2016 have been eliminated.

Reclassifications

Certain prior year items have been reclassified to conform to the current year presentation.

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NOTE 3 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Estimates

The preparation of the Company's consolidated financial statements in conformity with GAAP requires management to make estimates and assumptions that affect certain reported amounts and disclosures. Significant estimates include the allowance for uncollectible accounts receivable, depreciation and amortization, intangible assets, including software development cost, customer lists and technology stacks, capitalization, fair value and useful lives, accruals, contingencies, impairment and valuation of stock warrants and options. These estimates may be adjusted as more current information becomes available, and any adjustment could have a significant impact on recorded amounts. Accordingly, actual results could defer from those estimates.

Fair Value of Financial Instruments

The Company considers the carrying amounts of financial instruments, including cash, accounts receivable, accounts payable, accrued expenses and notes payable to approximate their fair values because of their relatively short maturities.

The Company reviews the terms of the convertible debt and equity instruments that it issues to determine whether there are embedded derivative instruments, including embedded conversion options that are required to be bifurcated and accounted for separately as derivative financial instruments. In connection with the sale of convertible debt and equity instruments, the Company may issue freestanding warrants that may, depending on their terms, be accounted for as derivative instrument liabilities, rather than as equity.

Bifurcated embedded derivatives are initially recorded at fair value and are then revalued at each reporting date with changes in the fair value reported as non-operating income or expense. When the convertible debt or equity instruments contain embedded derivative instruments that are to be bifurcated and accounted for as liabilities, the total proceeds allocated to the convertible host instruments are first allocated to the fair value of all the bifurcated derivative instruments. The remaining proceeds, if any, are then allocated to the convertible instruments themselves, usually resulting in those instruments being recorded at a discount from their face amount. The discount from the face value of the convertible debt, together with the stated interest on the instrument, is amortized over the life of the instrument through periodic charges to interest expense, using the effective interest method.

Accounts and Unbilled Receivables

Accounts and unbilled receivables consist of amounts due from customers which are presented net of the allowance for doubtful accounts at the amount the Company expects to collect. The Company records a provision for doubtful receivables, if necessary, to allow for any amounts which may be unrecoverable, which is based upon an analysis of the Company's prior collection experience, customer creditworthiness, past transaction history with the customers, current economic trends, and changes in customer repayment terms.

Unbilled receivables are established when revenue is deemed to be recognized based on the Company's revenue recognition policy, but due to contractual restraints over the timing of invoicing, the Company does not have the right to invoice the customer by the balance sheet date.

Vendors and Contractors

The Company outsources portions of its work to third party service providers (See Note 16). These providers include captive suppliers that undertake software development, research & development and custom platform development.

Some vendors may provide specific consultants or resources (often called Corp to Corp) or independent contractors (often designated as 1099) to satisfy agreed deliverables to the Company's clients.

Equipment

Equipment is recorded at cost and depreciated for financial statement purposes using the straight-line method over estimated useful lives of five (5) to fifteen (15) years. Maintenance and repairs are charged to operating expenses as they are incurred. Improvements and betterments, which extend the lives of the assets, are capitalized. The cost and accumulated depreciation of assets retired or otherwise disposed of are removed from the appropriate amounts and any profit or loss on the sale or disposition of assets is credited or charged to income.

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Inventory

Inventory consists primarily of manufactured and preassembled units ready for distribution. Inventory is stated at the lower of cost (first-in, first-out) or market. In evaluating whether inventory is stated lower of cost or market, management considers such factors as the amount of inventory on hand, the distribution channel, the estimated time to sell such inventory, and the current market conditions. Adjustments to reduce inventory to its net realizable value are charged to cost of goods sold.

Intangible Assets

Intangible assets, consisting of customer lists and technology stacks, are recorded at fair value and amortized on the straight-line method over the estimated useful lives of the related assets.

The carrying value of intangible assets are reviewed for impairment by management of the Company at least annually or upon the occurrence of an event which may indicate that the carrying amount may be greater than its fair value. Management of the Company performs its impairment testing on a quarterly basis. If impaired, the Company will write-down such impairment. In addition, the useful life of the intangible assets will be evaluated by management at least annually or upon the occurrence of an event which may indicate that the useful life may have changed.

Customer lists are valued based on management's forecast of expected future net cash flows, with revenues based on projected revenues from customers acquired and are being amortized over years ranging from 2 to 5 years.

Technology stacks are valued based on management's forecast of expected future net cash flows, with revenues based on projected sales of these technologies and are amortized over years ranging from 2 to 7 years.

Software Development Costs

Costs that are related to the conceptual formulation and design of licensed software programs are expensed as incurred to research, development (R&D) engineering and other administrative support expenses; costs that are incurred to produce the finished product after technological feasibility has been established and after all research and development activities for any other components of the product or process have been completed are capitalized as software development costs. Capitalized amounts are amortized on a straight-line basis over periods ranging up to five years and are recorded in amortization expense which started during 2015 and 2016 when certain of the Platforms first became available for sale. The Company performs reviews at each balance sheet date to ensure that unamortized software development costs remain recoverable from future revenue. Cost to support or service licensed Platforms are charged to cost of revenue as incurred.

The Company's product development and R&D are carried out by both our employees in the U.S. as well as outsourced contractors in India. The U.S. employees mainly focus on the domain, market relevance, feasibility and possible pilots/prototypes. The Indian contractors mainly focus on execution in terms of software development and testing.

Pre-paid Expenses

The Company incurs certain costs that are deemed as prepaid expenses. The fees that are paid to the Department of Homeland Security for processing H-1B visa fees for its international employees are amortized over 36 months, typically the life of the visa. One-third of these pre-paid expenses are included in other current assets and two-thirds in other assets. The Company also incurs certain expenses towards the licensing of its platforms and may include special software development costs, testing and commissions.

Deferred Financing Costs

In accordance with FASB ASU 2015-03, Interest-Imputation of Interest (Subtopic 835-30): Simplifying the Presentation of Debt Issuance Costs (ASU 2015-03), the Company has reclassified debt Issuance costs, previously presented as another long-term asset, to a direct deduction from the carrying value of the associated debt liability, consistent with the presentation of a debt discount.

Financing costs incurred in connection with the Company's notes payable and revolving credit facilities are capitalized and amortized into expense using the straight-line method over the life of the respective facility (See Note 10).

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Deferred Licensing and Royalty Fees

The Company licenses software, platforms and/or content on an as-needed basis and enters into market driven licensing and royalty fee arrangements. If no consumption or usage of such licenses occurs during the reporting period, the Company has no obligation for any minimum fees or royalties and no accruals are posted. Deferred licensing fees are amortized over a period of five years.

Deferred Licensing Revenue

The Company may enter into agreements to license its Platforms and may receive upfront fees as an advance. These fees will be recognized as revenues when the client accepts the delivery of such licenses.

Operating Leases

The Company has operating lease agreements for its offices, some of which contain provisions for future rent increases or periods in which rent payments are abated. Operating leases which provide for lease payments that vary materially from the straight-line basis are adjusted for financial accounting purposes to reflect rental income or expense on the straight-line basis in accordance with the authoritative guidance issued by the Financial Accounting Standards Board ("FASB"). No such material difference existed as of June 30, 2016 and June 30, 2015.

Financial Instruments

The Company does not use derivative instruments to hedge exposures to cash flow, market or foreign currency risks.

The Company reviews the terms of the convertible debt and equity instruments that it issues to determine whether there are embedded derivative instruments, including embedded conversion option, that are required to be bifurcated and accounted for separately as derivative financial instruments. In connection with the sale of convertible debt and equity instruments, the Company may issue freestanding warrants that may, depending on their terms, be accounted for as derivative instrument liabilities, rather than as equity.

Bifurcated embedded derivatives are initially recorded at fair value and are then revalued at each reporting date with changes in the fair value reported as non-operating income or expense. When the convertible debt or equity instruments contain embedded derivative instruments that are to be bifurcated and accounted for as liabilities, the total proceeds allocated to the convertible host instruments are first allocated to the fair value of all the bifurcated derivative instruments. The remaining proceeds, if any, are then allocated to the convertible instruments themselves, usually resulting in those instruments being recorded at a discount from their face amount.

The discount from the face value of the convertible debt, together with the stated interest on the instrument, is amortized over the life of the instrument through periodic charges to interest expense, using the effective interest method.

Goodwill

In connection with the Company's acquisitions, valuations are usually completed to determine the allocation of the purchase prices. The factors considered in the valuations include data gathered as a result of the Company's due diligence in connection with the acquisitions, projections for future operation, and data obtained from third-party valuation specialists as deemed appropriate. Goodwill represents the future economic benefits of a business combination measured as the excess purchase price over the fair market value of net assets acquired.

Goodwill and intangible assets acquired in a purchase business combination and determined to have an indefinite useful life are not amortized, but tested for impairment at least annually or more frequently if events and circumstances exists that indicate that a goodwill impairment test should be performed. The Company has selected December 31 as the date to perform the annual impairment test. Intangible assets with definite useful lives are amortized over their estimated useful lives to their estimated residual values.

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Revenue Recognition

Revenue is recognized when there is persuasive evidence of an arrangement, the fee is fixed and determinable, performance of service has occurred and collection is reasonably assured. Revenue is recognized in the period the services are provided, which range from approximately 2 months to over 1 year. The Company specifically recognizes three kinds of revenues:

1. Time and materials – consulting and project engagements fall in this category and revenues are recognized when the client approves the time sheet of consultants who have completed work on their assignment.