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

FORM 10-Q

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

For the quarterly period ended: June 30, 2022

☐ Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

Commission file number: 001-08443

TELOS CORPORATION

(Exact name of registrant as specified in its charter)

Maryland	**52-0880974**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
19886 Ashburn Road, Ashburn, Virginia	**20147-2358**
(Address of principal executive offices)	(Zip Code)

(703) 724-3800
(Registrant's telephone number, including area code)

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

Title of each class	Trading symbol	Name of each exchange on which registered
Common stock, $0.001 par value per share	TLS	The Nasdaq Stock Market LLC

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

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

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

Large accelerated filer	☒	Accelerated filer	☐
Non-accelerated filer	☐	Smaller reporting company	☐
		Emerging growth company	☐

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

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

As of August 5, 2022, the registrant had outstanding 67,593,945 shares of common stock.

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PART I - FINANCIAL INFORMATION

Item 1. Financial Statements.

Telos Corporation
Consolidated Statements of Operations
(Unaudited)

	For the Three Months Ended		For the Six Months Ended	
	June 30, 2022	June 30, 2021	June 30, 2022	June 30, 2021
	(in thousands, except per share amounts)			
Revenue – services	$ 50,270	$ 49,003	$ 98,378	$ 101,061
Revenue – products	5,521	4,641	7,573	8,341
Total revenue	55,791	53,644	105,951	109,402
Cost of sales – services	31,436	28,609	61,167	68,099
Cost of sales – products	3,426	2,501	4,984	4,299
Total cost of sales	34,862	31,110	66,151	72,398
Gross profit	20,929	22,534	39,800	37,004
Selling, general and administrative expenses:				
Sales and marketing	4,741	5,043	9,993	8,869
Research and development	4,489	5,327	9,919	9,388
General and administrative	23,865	29,635	46,788	49,712
Total selling, general and administrative expenses	33,095	40,005	66,700	67,969
Operating loss	(12,166)	(17,471)	(26,900)	(30,965)
Other income/(expense)	118	32	130	(1,022)
Interest expense	(187)	(192)	(377)	(388)
Loss before income taxes	(12,235)	(17,631)	(27,147)	(32,375)
Provision for income taxes	(54)	(13)	(125)	(47)
Net loss	$ (12,289)	$ (17,644)	$ (27,272)	$ (32,422)
Net loss per share:				
Basic	$ (0.18)	$ (0.26)	$ (0.40)	$ (0.49)
Diluted	$ (0.18)	$ (0.26)	$ (0.40)	$ (0.49)
Weighted average shares outstanding:				
Basic	67,876	66,616	67,717	65,621
Diluted	67,876	66,616	67,717	65,621

See accompanying notes to unaudited consolidated financial statements.

Telos Corporation
Consolidated Statements of Comprehensive Loss
(Unaudited)

	For the Three Months Ended		For the Six Months Ended	
	June 30, 2022	June 30, 2021	June 30, 2022	June 30, 2021
	(in thousands)			
Net loss	$ (12,289)	$ (17,644)	$ (27,272)	$ (32,422)
Other comprehensive (loss)/income, net of tax:				
Foreign currency translation adjustments	(11)	5	18	(27)
Comprehensive loss	$ (12,300)	$ (17,639)	$ (27,254)	$ (32,449)

See accompanying notes to unaudited consolidated financial statements.

Telos Corporation
Consolidated Balance Sheets
(Unaudited)

	June 30, 2022	December 31, 2021
	(in thousands, except per share and share data)	
Assets:		
Cash and cash equivalents	$ 122,588	$ 126,562
Accounts receivable, net	50,676	59,844
Inventories, net	3,630	1,247
Prepaid expenses	6,778	3,329
Other current assets	947	732
Total current assets	184,619	191,714
Property and equipment, net	5,571	6,088
Finance lease right-of-use assets, net	8,442	9,053
Operating lease right-of-use assets	569	852
Goodwill	17,922	17,922
Intangible assets, net	23,783	19,199
Other assets	1,052	1,253
Total assets	$ 241,958	$ 246,081
Liabilities and Stockholders' Equity:		
Liabilities:		
Accounts payable and other accrued liabilities	$ 35,412	$ 34,548
Accrued compensation and benefits	9,280	6,557
Contract liabilities	4,799	6,381
Finance lease obligations, current portion	1,525	1,461
Operating lease obligations, current portion	450	564
Other current liabilities	2,734	1,430
Total current liabilities	54,200	50,941
Finance lease obligations, non-current portion	12,066	12,840
Operating lease liabilities, non-current portion	192	388
Deferred income taxes	748	723
Other liabilities	440	935
Total liabilities	67,646	65,827
Commitments and contingencies (Note 19)		
Stockholders' equity		
Common stock, $0.001 par value, 250,000,000 shares authorized, 67,594,301 shares and 66,767,450 shares issued and outstanding as of June 30, 2022 and December 31, 2021, respectively	106	105
Additional paid-in capital	388,464	367,153
Accumulated other comprehensive loss	(9)	(27)
Accumulated deficit	(214,249)	(186,977)
Total stockholders' equity	174,312	180,254
Total liabilities and stockholders' equity	$ 241,958	$ 246,081

See accompanying notes to unaudited consolidated financial statements.

Telos Corporation
Consolidated Statements of Cash Flows
(Unaudited)

	For the Six Months Ended	
	June 30, 2022	June 30, 2021
	(in thousands)	
Cash flows from operating activities:		
Net loss	$ (27,272)	$ (32,422)
Adjustments to reconcile net loss to cash flows provided by/(used in) operating activities:		
Stock-based compensation	29,504	35,006
Depreciation and amortization	2,910	2,764
Deferred income tax provision	25	18
Accretion of discount on acquisition holdback	23	—
Loss on disposal of fixed assets	1	5
Provision for doubtful accounts	66	11
(Recovery from)/provision for inventory obsolescence	(108)	14
Changes in other operating assets and liabilities		
Accounts receivable	9,102	(9,595)
Inventories	(2,275)	1,513
Prepaid expenses, other current assets, and other assets	(3,324)	(2,417)
Accounts payable and other accrued payables	567	1,278
Accrued compensation and benefits	419	632
Contract liabilities	(1,582)	271
Other current liabilities and other liabilities	76	(432)
Net cash provided by/(used in) operating activities	8,132	(3,354)
Cash flows from investing activities:		
Capitalized software development costs	(5,134)	(3,663)
Purchases of property and equipment	(641)	(1,070)
Net cash used in investing activities	(5,775)	(4,733)
Cash flows from financing activities:		
Payments under finance lease obligations	(710)	(650)
Payment of tax withholding related to net share settlement of equity awards	(2,886)	—
Repurchase of common stock	(2,603)	(1,251)
Proceeds from issuance of common stock, net of issuance costs	—	64,269
Repurchase of outstanding warrants	—	(26,894)
Distributions to Telos ID Class B member – non-controlling interest	—	(2,436)
Net cash (used in)/provided by financing activities	(6,199)	33,038
Net change in cash, cash equivalents, and restricted cash	(3,842)	24,951
Cash, cash equivalents and restricted cash, beginning of period	126,562	106,045
Cash, cash equivalents and restricted cash, end of period	$ 122,720	$ 130,996

See accompanying notes to unaudited consolidated financial statements.

Telos Corporation
Consolidated Statements of Changes in Stockholders' Equity
(Unaudited)

	Common Stock		Additional Paid-in Capital	Accumulated Other Comprehensive Income/(Loss)	Accumulated Deficit	Total Stockholders' Equity
	Shares	Amount				
	(in thousands)					
Balance at March 31, 2022	67,867	$ 106	$ 376,913	$ 2	$ (201,960)	$ 175,061
Net loss	—	—	—	—	(12,289)	(12,289)
Foreign currency translation loss	—	—	—	(11)	—	(11)
Stock-based compensation expense, excluding accrued compensation	—	—	14,553	—	—	14,553
Repurchase of common stock	(360)	—	(3,002)	—	—	(3,002)
RSUs vested, net of shares withheld to cover tax withholding	87	—	—	—	—	—
Balance at June 30, 2022	67,594	$ 106	$ 388,464	$ (9)	$ (214,249)	$ 174,312
Balance at March 31, 2021	64,625	$ 103	$ 284,470	$ 12	$ (158,621)	$ 125,964
Net loss	—	—	—	—	(17,644)	(17,644)
Issuance of common stock	2,050	2	64,267	—	—	64,269
Foreign currency translation gain	—	—	—	5	—	5
Stock-based compensation expense	—	—	21,336	—	—	21,336
Repurchase of outstanding warrants	—	—	(26,894)	—	—	(26,894)
Repurchase of common stock	(40)	—	(1,251)	—	—	(1,251)
Balance at June 30, 2021	66,635	$ 105	$ 341,928	$ 17	$ (176,265)	$ 165,785

	Common Stock		Additional Paid-in Capital	Accumulated Other Comprehensive Income/(Loss)	Accumulated Deficit	Total Stockholders' Equity
	Shares	Amount				
	(in thousands)					
Balance at December 31, 2021	66,767	$ 105	$ 367,153	$ (27)	$ (186,977)	$ 180,254
Net loss	—	—	—	—	(27,272)	(27,272)
Foreign currency translation gain	—	—	—	18	—	18
Stock-based compensation expense, excluding accrued compensation	—	—	27,200	—	—	27,200
Repurchase of common stock	(360)	—	(3,002)	—	—	(3,002)
RSUs vested, net of shares withheld to cover tax withholding	1,187	1	(2,887)	—	—	(2,886)
Balance at June 30, 2022	67,594	$ 106	$ 388,464	$ (9)	$ (214,249)	$ 174,312
Balance at December 31, 2020	64,625	$ 103	$ 270,800	$ 44	$ (143,843)	$ 127,104
Net loss	—	—	—	—	(32,422)	(32,422)
Issuance of common stock	2,050	2	64,267	—	—	64,269
Foreign currency translation loss	—	—	—	(27)	—	(27)
Stock-based compensation expense	—	—	35,006	—	—	35,006
Repurchase of outstanding warrants	—	—	(26,894)	—	—	(26,894)
Repurchase of common stock	(40)	—	(1,251)	—	—	(1,251)
Balance at June 30, 2021	66,635	$ 105	$ 341,928	$ 17	$ (176,265)	$ 165,785

See accompanying notes to unaudited consolidated financial statements.

Telos Corporation
Notes to the Unaudited Consolidated Financial Statements

1. ORGANIZATION

Telos Corporation, together with its subsidiaries (collectively, the "Company," "we," "our" or "Telos"), a Maryland corporation, is a leading provider of cyber, cloud and enterprise security solutions for the world's most security-conscious organizations. We own all of the issued and outstanding share capital of Xacta Corporation, a subsidiary that develops, markets and sells government-validated secure enterprise solutions to government and commercial customers. We also own all of the issued and outstanding share capital of Ubiquity.com, Inc., a holding company for Xacta Corporation. We also have a 100% ownership interest in Telos Identity Management Solutions, LLC ("Telos ID"), Teloworks, Inc. ("Teloworks") and Telos APAC Pte. Ltd. ("Telos APAC").

On November 12, 2020, we amended our charter to effect an approximate 0.794-for-1 reverse stock split with respect to our common stock. The par value and the authorized shares of the common stock were not adjusted as a result of the reverse stock split. The accompanying consolidated financial statements and notes to the consolidated financial statements give retroactive effect to the reverse stock split for all periods presented.

On November 19, 2020, we completed our initial public offering ("IPO") of shares of our common stock. We issued 17.2 million shares of our common stock at a price of $17.00 per share, generating net proceeds of approximately $272.8 million. We used approximately $108.9 million of the net proceeds in connection with the conversion of our outstanding shares of Exchangeable Redeemable Preferred Stock into the right to receive cash and shares of our common stock, $30.0 million to fund our acquisition of the outstanding Class B Units of Telos ID, and $21.0 million to repay our outstanding senior term loan and subordinated debt. We intend to use the remaining net proceeds for general corporate purposes.

On April 6, 2021, we completed our follow-on offering of 9.1 million shares of our common stock at a price of $33.00 per share, including 7.0 million shares of common stock held by certain existing stockholders of Telos. The offering generated approximately $64.3 million of net proceeds to Telos. We did not receive any proceeds from the shares of common stock sold by the selling stockholders. On April 19, 2021, we used approximately $1.3 million of the net proceeds to repurchase 39,682 shares of our common stock and $26.9 million to repurchase the warrants to purchase 900,970 shares of our common stock owned by certain affiliates of Enlightenment Capital Solutions ("EnCap"). We intend to use the remaining net proceeds for general corporate purposes.

2. SIGNIFICANT ACCOUNTING POLICIES

(a) Basis of Presentation

The accompanying unaudited consolidated financial statements include the accounts of Telos and its subsidiaries, including Ubiquity.com, Inc., Xacta Corporation, Telos ID, Teloworks, and Telos APAC, all of whose issued and outstanding share capital is wholly-owned directly and indirectly by Telos Corporation. All intercompany transactions have been eliminated in consolidation.

(b) Basis of Presentation for Interim Periods

Certain information and footnote disclosures normally included for the annual financial statements prepared in accordance with accounting principles generally accepted in the United States of America ("U.S. GAAP") have been condensed or omitted for the interim periods presented. We believe that the unaudited interim financial statements include all adjustments (which are normal and recurring in nature) necessary to state fairly our financial position and the results of operations and cash flows for the periods presented.

The results of operations for the interim periods presented are not necessarily indicative of results that may be expected for the year or future periods. The financial statements should be read in conjunction with our audited consolidated financial statements and the notes thereto for the year ended December 31, 2021, included in our Annual Report on Form 10-K for the fiscal year then ended (the "2021 10-K"). We have continued to follow the accounting policies set forth in those financial statements.

(c) Segment Reporting

Operating segments are defined as components of an enterprise for which separate discrete financial information is available and evaluated regularly by the chief operating decision maker ("CODM"), or decision-making group, in deciding how to allocate resources and assess performance.

During the fourth quarter of 2021, we reorganized our internal management reporting structure and the financial results evaluated by our CODM; therefore, we changed our operating segments to align with how our CODM currently oversees the business, allocates resources and evaluates operating performance. As a result of the segment reorganization, we reported two reportable and operating segments: Security Solutions and Secure Networks. The segments enable the alignment of our strategies and objectives and provide a framework for timely and rational allocation of resources within the lines of business. We eliminate any inter-segment revenues and expenses upon consolidation.

Prior period segment information has been recast to reflect the change. The segment reorganization had no impact on previously reported unaudited consolidated financial results.

(d) Basis of Comparison – Revision of Previously Issued Interim Financial Statements

The Company recorded certain revisions related to the previously issued unaudited condensed consolidated financial statements. The Company considered the errors identified in accordance with the SEC's Staff Accounting Bulletin No. 99 and determined the impact was immaterial to the previously issued condensed consolidated interim financial statements. Nonetheless, the Company corrected these errors when identified in 2021.

During the third quarter of 2021, the Company identified out-of-period adjustments on certain revenue and expense classification. Further, we corrected the cash flow presentation to properly reflect the final payment to fully acquire all of the membership interest of Telos ID as financing activities. Further information regarding the misstatements and related revisions are included in Note 18 – Revision of Prior Year Interim Financial Statements to the condensed consolidated financial statements.

(e) Use of Estimates

The preparation of unaudited consolidated financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect the reported amounts of revenue, expenses, assets and liabilities and disclosure of contingent assets and liabilities. The Company regularly assesses these estimates; however, actual results could differ from those estimates. We base our estimates on historical experience, currently available information and various other assumptions that we believe are reasonable under the circumstances. The most significant items involving management estimates include estimates of revenue recognition, allowance for credit losses, allowance for inventory obsolescence, the valuation allowance for deferred tax assets, the provision for income taxes, share-based compensation, contingencies and litigation, and valuation of intangibles and goodwill. The impact of changes in estimates is recorded in the period in which they become known.

(f) Recent Accounting Pronouncements

Changes to U.S. GAAP are established by the Financial Accounting Standards Board ("FASB") in the form of Accounting Standards Updates ("ASUs") to the FASB's Accounting Standards Codification ("ASC"). We consider the applicability and impact of all recent ASUs. ASUs not listed below were assessed and determined to be not applicable.

Accounting Pronouncements Not Yet Adopted

In October 2021, the FASB issued ASU No. 2021-08, “Business Combination (Topic 805): Accounting for Contract Assets and Contract Liabilities from Contracts with Customers,” which requires entities to apply Topic 606 to recognize and measure contract assets and contract liabilities in a business combination. The ASU improves comparability after the business combination by providing consistent recognition and measurement guidance for revenue contracts with customers acquired in a business combination and revenue contracts with customers not acquired in a business combination. Entities should apply the amendments prospectively to business combinations that occur after the effective date. This standard will be effective for reporting periods beginning after December 15, 2022, with early adoption permitted. While we are currently assessing the impact of the adoption of this ASU, we do not believe the adoption of this ASU will have a material impact on our unaudited consolidated financial position, results of operations and cash flows.

In June 2022, the FASB issued ASU No. 2022-03, "Fair Value Measurement (Topic 820): Fair Value Measurement of Equity Securities Subject to Contractual Sale Restrictions," which clarifies that a contractual restriction on the sale of an equity security is not considered part of the unit of account of the equity security and, therefore, is not considered in measuring fair value. This standard will be effective for reporting periods beginning December 15, 2023, with early adoption permitted. While we are currently assessing the impact of the adoption of this ASU, we do not believe the adoption of this ASU will have a material impact on our unaudited consolidated financial position, results of operations and cash flows.

3. REVENUE RECOGNITION

We recognize revenue in accordance with ASC Topic 606, "Revenue from Contracts with Customers." The unit of account in ASC 606 is a performance obligation, which is a promise in a contract with a customer to transfer a good or service to the customer.

The majority of our revenue is recognized over time, as control is transferred continuously to our customers who receive and consume benefits as we perform, and is classified as services revenue. Revenue transferred to customers over time accounted for 90% and 93% of our revenue for the three and six months ended June 30, 2022, and 91% and 92% of our revenue for the three and six months ended June 30, 2021, respectively. All of our business groups earn services revenue under a variety of contract types, including time and materials, firm-fixed price, firm-fixed price level of effort, and cost-plus fixed fee contract types, which may include variable consideration as discussed further below.

Revenue transferred to customers at a point in time accounted for 10% and 7% of our revenue for the three and six months ended June 30, 2022, and 9% and 8% of our revenue for the three and six months ended June 30, 2021, respectively. Revenue on these contracts is recognized when the customer obtains control of the transferred product or service, which is generally upon delivery of the product to the customer for their use, due to us maintaining control of the product until that point.

For certain performance obligations where we are not primarily responsible for fulfilling the promise to provide the goods or services to the customer, do not have inventory risk and have limited discretion in establishing the price for the goods or services, we recognize revenue on a net basis.

We provide for anticipated losses on contracts during the period when the loss is determined by recording an expense for the total expected costs that exceed the total estimated revenue for a performance obligation. No contract losses were recorded during the three and six months ended June 30, 2022 and 2021.

Disaggregated Revenues

We have identified two reportable segments. We treat sales to U.S. customers as sales within the U.S., regardless of where the services are performed. Substantially all of our revenues are generated from U.S. customers.

Table 3.1: Revenue by Operating Segments

	For the Three Months Ended		For the Six Months Ended	
	June 30, 2022	June 30, 2021	June 30, 2022	June 30, 2021
	(in thousands)			
Security Solutions:				
Services	$ 25,298	$ 27,595	$ 50,165	$ 46,725
Products	5,521	4,641	7,573	8,341
Total Security Solutions revenue	30,819	32,236	57,738	55,066
Secure Networks:				
Services	24,972	21,408	48,213	54,336
Products	—	—	—	—
Total Secure Networks revenue	24,972	21,408	48,213	54,336
Total revenue	$ 55,791	$ 53,644	$ 105,951	$ 109,402

Table 3.2: Revenue by Customer Type

	For the Three Months Ended		For the Six Months Ended	
	June 30, 2022	June 30, 2021	June 30, 2022	June 30, 2021
	(in thousands)			
Security Solutions:				
Federal	$ 27,251	$ 29,830	$ 51,853	$ 50,281
State & local, and commercial	3,568	2,406	5,885	4,785
Total Security Solutions revenue	30,819	32,236	57,738	55,066
Secure Networks:				
Federal	24,962	21,302	48,203	54,198
State & local, and commercial	10	106	10	138
Total Secure Networks revenue	24,972	21,408	48,213	54,336
Total revenue	$ 55,791	$ 53,644	$ 105,951	$ 109,402

Table 3.3: Revenue by Contract Type

	For the Three Months Ended		For the Six Months Ended	
	June 30, 2022	June 30, 2021	June 30, 2022	June 30, 2021
	(in thousands)			
Security Solutions:				
Firm fixed-price	$ 26,275	$ 27,457	$ 48,742	$ 45,469
Time-and-materials	2,731	3,059	5,646	6,060
Cost plus fixed fee	1,813	1,720	3,350	3,537
Total Security Solutions revenue	$ 30,819	$ 32,236	$ 57,738	$ 55,066
Secure Networks:				
Firm fixed-price	19,030	18,885	37,839	50,014
Time-and-materials	—	—	—	29
Cost plus fixed fee	5,942	2,523	10,374	4,293
Total Secure Networks revenue	24,972	21,408	48,213	54,336
Total revenue	$ 55,791	$ 53,644	$ 105,951	$ 109,402

Revenue resulting from contracts and subcontracts with the U.S. government accounted for 94% and 95% of our revenue for the three months ended June 30, 2022 and 2021, respectively, and 94% and 96% of our revenue for the six months ended June 30, 2022 and 2021, respectively. As our primary customer base includes agencies of the U.S. government, we have a concentration of credit risk associated with our accounts receivable, as 95% of our billed accounts receivable as of June 30, 2022, were directly with U.S. government customers. We perform ongoing credit evaluations of all our customers and generally do not require collateral or other guarantee from our customers. We maintain allowances for potential losses.

Table 3.4: Revenue Concentrations Greater than 10% of Total Revenue

	For the Three Months Ended		For the Six Months Ended	
	June 30, 2022	June 30, 2021	June 30, 2022	June 30, 2021
U.S. Department of Defense ("DoD")	72%	67%	71%	76%
Civilian	22%	28%	23%	20%

Contract Balances

Table 3.5: Contract Balances

	June 30, 2022	**December 31, 2021**
	(in thousands)	
Contract assets (unbilled receivables)	$ 36,216	$ 41,374
Contract liabilities	4,799	6,381

The change in the Company's contract assets and contract liabilities during the period were primarily the result of the timing differences between the Company's performance, invoicing and customer payments. Revenue recognized for the three and six months ended June 30, 2022, that was included in the contract liabilities balance at the beginning of each reporting period was $1.6 million and $4.1 million, respectively. Revenue recognized for the three and six months ended June 30, 2021, that was included in the contract liabilities balance at the beginning of each reporting period was $1.2 million and $3.2 million, respectively.

As of June 30, 2022, we had $100.5 million of remaining performance obligations, which we also refer to as funded backlog. We expect to recognize approximately 76% of our remaining performance obligations as revenue in 2022, an additional 20% in 2023, and the balance thereafter.

4. ACCOUNTS RECEIVABLE, NET

Table 4: Details of Accounts Receivable, Net

	June 30, 2022	December 31, 2021
	(in thousands)	
Billed accounts receivable	$ 14,638	$ 18,586
Unbilled receivables	36,216	41,374
Allowance for credit losses	(178)	(116)
Accounts receivable, net	$ 50,676	$ 59,844

5. INVENTORIES, NET

Table 5: Details of Inventories, Net

	June 30, 2022	December 31, 2021
	(in thousands)	
Gross inventory	$ 4,383	$ 2,108
Allowance for inventory obsolescence	(753)	(861)
Inventories, net	$ 3,630	$ 1,247

6. PROPERTY AND EQUIPMENT, NET

Table 6: Details of Property and Equipment, Net

	June 30, 2022	December 31, 2021
	(in thousands)	
Furniture and equipment	$ 15,866	$ 15,420
Leasehold improvement	3,009	2,994
Property and equipment, at cost	18,875	18,414
Accumulated depreciation	(13,304)	(12,326)
Property and equipment, net	$ 5,571	$ 6,088

Depreciation expense was $0.5 million and $1.2 million for the three and six months ended June 30, 2022, respectively, compared to $0.5 million and $0.9 million for the three and six months ended June 30, 2021.

7. GOODWILL

The goodwill balance was $17.9 million as of June 30, 2022, and December 31, 2021, of which $3.0 million is allocated to the Security Solutions segment and $14.9 million is allocated to the Secure Networks segment. Goodwill is subject to annual impairment tests and if triggering events are present in the interim before the annual tests, we will assess impairment. For the three and six months ended June 30, 2022 and 2021, no impairment charges were taken.

8. INTANGIBLE ASSETS, NET

Table 8.1: Details of Intangible Assets, Net

	June 30, 2022			December 31, 2021		
	Gross	Accumulated Amortization	Net	Gross	Accumulated Amortization	Net
	(in thousands)					
Acquired technology	$ 3,630	$ (416)	$ 3,214	$ 3,630	$ (256)	$ 3,374
Customer relationships	40	(12)	28	40	(5)	35
Software development costs	27,652	(7,111)	20,541	22,222	(6,432)	15,790
	$ 31,322	$ (7,539)	$ 23,783	$ 25,892	$ (6,693)	$ 19,199

Amortization expense was $0.4 million and $0.8 million for the three and six months ended June 30, 2022, respectively, and $0.5 million and $0.9 million for the three and six months ended June 30, 2021, respectively.

9. ACQUISITION

On July 30, 2021, the Company acquired the assets of Diamond Fortress Technologies ("DFT") and wholly-owned subsidiaries for a total purchase consideration of $6.7 million, inclusive of $0.3 million related to a pre-existing contractual arrangement with DFT. Upon closing, $5.9 million of cash was paid with an additional $0.6 million payable to DFT 18 months after the close date (the "holdback"). The holdback amount has been discounted to its present value of $0.5 million using a discount rate relevant to the acquisition. The acquisition adds several new patents to the Company’s library of biometric and digital identity intellectual property. The addition of contactless biometrics technology will enable the Company to better serve the needs of organizations in existing and new markets. The acquisition of the assets of DFT has been accounted for under U.S. GAAP using the acquisition method of accounting. The total purchase consideration of $6.7 million has been allocated among the assets acquired at their fair value at the acquisition date.

The Company recognized $3.7 million of intangible assets and $3.0 million of goodwill, which is housed in the Telos ID reporting unit, part of the Security Solutions operating segment. Goodwill is primarily attributable to an excess of the purchase price over the acquired identifiable net tangible and intangible assets. The acquired intangible assets will be amortized on a straight-line basis over 3 - 8 years. The acquisition was considered an asset purchase for tax purposes and the recognized goodwill is deductible for tax purposes.

10. PURCHASE OF TELOS ID NON-CONTROLLING INTERESTS

Telos ID was formed as a limited liability company under the Delaware Limited Liability Company Act in 2007. Prior to the IPO, the Company owned a 50% interest in Telos ID, with the remaining interest owned by Hoya ID Fund A, LLC ("Hoya") as the non-controlling interest. Distributions were made to the members only when and to the extent determined by Telos ID's Board of Directors, in accordance with its Operating Agreement.

On October 5, 2020, we entered into a Membership Interest Purchase Agreement between the Company and Hoya to purchase all of the Class B Units of Telos ID owned by Hoya (the "Telos ID Purchase"). Upon the closing of the Telos ID Purchase, Telos ID became our wholly owned subsidiary. On November 23, 2020, the Telos ID Purchase was consummated with the Company transferring $30.0 million in cash and issuing 7.3 million shares of our common stock at $20.39 per share (which totals approximately $148.4 million); the total consideration transferred to Hoya was $178.4 million. As part of the common stock issuance, the Company recognized an increase to additional paid-in capital ("APIC") of $148.4 million. The Company further recognized a reduction to APIC of $173.9 million as part of the elimination of Hoya's non-controlling interest in Telos ID. The net impact to APIC associated with the acquisition of the additional 50% interest in Telos ID was a reduction of $25.5 million. Hoya received a final distribution of $2.4 million in January 2021.

11. ACCOUNTS PAYABLE AND OTHER ACCRUED LIABILITIES

Table 11: Details of Accounts Payable and Other Accrued Liabilities

	June 30, 2022	December 31, 2021
	(in thousands)	
Accounts payable - trade	$ 15,929	$ 7,869
Accrued liabilities	18,109	25,300
Others	1,374	1,379
Accounts payable and other accrued liabilities	$ 35,412	$ 34,548

12. STOCK-BASED COMPENSATION

Our 2016 Omnibus Long-Term Incentive Plan (the "2016 LTIP") provides for the grant of restricted stock units with time-based vesting ("Service-Based RSU" or "RSU") and restricted stock units with performance-based vesting (Performance-Based RSU" or "PRSU") to our senior executives, directors, employees, and other service providers. Awards granted under the 2016 LTIP vest over the periods determined by the Board of Directors or the Compensation Committee of the Board of Directors, generally one to three years. The Company records stock-based compensation related to accrued compensation in which it intends to settle in shares of the Company's common stock. However, it is the Company's discretion whether this compensation will ultimately be paid in stock or cash, as it has the right to dictate the form of these payments up until the date at which they are paid.

The stock-based compensation expense includes an immaterial adjustment of $0.7 million and $1.3 million for the three and six months ended June 30, 2022 related to the prior year. There were no income tax benefits recognized on the share-based compensation expense for both periods.

Table 12.1: Details of Stock Compensation Expense by Department

	For the Three Months Ended		For the Six Months Ended	
	June 30, 2022	June 30, 2021	June 30, 2022	June 30, 2021
	(in thousands)			
Cost of sales – services	$ 862	$ 631	$ 1,869	$ 1,256
Sales and marketing	1,420	2,233	3,088	3,780
Research and development	692	648	1,987	1,109
General and administrative	12,232	17,824	22,560	28,861
Total stock-based compensation expense	$ 15,206	$ 21,336	$ 29,504	$ 35,006

Table 12.2: Service-Based RSU and Performance-Based RSU Award Activity

	Service-Based RSU	Performance-Based RSU	Total	Weighted-Average Grant Date Fair Value
Unvested outstanding units as of December 31, 2021	3,030,608	492,727	3,523,335	$ 34.24
Granted	3,759,037	—	3,759,037	10.01
Vested	(1,416,116)	—	(1,416,116)	32.83
Forfeited	(260,588)	(113,566)	(374,154)	33.15
Unvested outstanding units as of June 30, 2022	5,112,941	379,161	5,492,102	$ 18.04

As of June 30, 2022, the intrinsic value of the RSUs and PRSUs outstanding, exercisable, and vested or expected to vest was $44.2 million. There was $61.0 million of total compensation costs related to stock-based awards not yet recognized as of June 30, 2022, which is expected to be recognized on a straight-line basis over a weighted-average remaining vesting period of approximately 1.3 years.

13. SHARE REPURCHASES

On May 24, 2022, the Company announced that the Board of Directors approved a new share repurchase program ("SRP") authorizing the Company to repurchase up to $50.0 million of its common stock. Pursuant to this authorization, the Company may repurchase shares of its common stock on a discretionary basis from time to time through open market purchases. The repurchase program has no expiration date and may be modified, suspended, or terminated at any time. As of June 30, 2022, there was $47.0 million of the remaining authorization for future common stock repurchases under the SRP.

Table 13: Shares Repurchase Activity

	For the Three Months Ended		For the Six Months Ended	
	June 30, 2022	June 30, 2021	June 30, 2022	June 30, 2021
	(in thousands, except per share and share data)			
Amount paid for shares repurchased [(1)]	$ 3,002	$ —	$ 3,002	$ —
Number of shares repurchased	360,439	—	360,439	—
Average per share price paid [(1)]	$ 8.33	$ —	$ 8.33	$ —

(1) Includes commissions paid for repurchases on the open market.

As of August 5, 2022, the Company repurchased an additional 142,536 shares of its common stock, for $1.1 million since June 30, 2022.

14. ACCUMULATED OTHER COMPREHENSIVE LOSS

Our functional currency is the U.S. Dollar. For one of our wholly-owned subsidiaries, the functional currency is the local currency. For this subsidiary, the translation of its foreign currency into U.S. Dollars is performed for assets and liabilities using current foreign currency exchange rates in effect at the balance sheet date and for revenue and expense accounts using average foreign currency exchange rates during the periods presented. Translation gains and losses are included in stockholders' equity as a component of accumulated other comprehensive loss.

Table 14: Details of Accumulated Other Comprehensive Loss

	June 30, 2022	December 31, 2021
	(in thousands)	
Cumulative foreign currency translation loss	$ (116)	$ (134)
Cumulative actuarial gain on pension liability adjustment	107	107
Accumulated other comprehensive loss	$ (9)	$ (27)

15. LOSS PER SHARE

Basic net earnings (loss) per share is computed by dividing the net earnings (loss) by the weighted-average number of common shares outstanding for the period, without consideration for potentially dilutive securities. Diluted net earnings (loss) per share is computed by dividing the net earnings (loss) by the weighted-average number of shares of common stock and dilutive common stock equivalents outstanding for the period determined using the treasury-stock and if-converted methods. Dilutive common stock equivalents are comprised of unvested restricted common stock and warrants.

For the period of net loss, potentially dilutive securities are not included in the calculation of diluted net earnings (loss) per share, because to do so would be anti-dilutive.

Table 15: Potentially Dilutive Securities

	For the Three Months Ended		For the Six Months Ended	
	June 30, 2022	June 30, 2021	June 30, 2022	June 30, 2021
	(in thousands)			
Unvested restricted stock and restricted stock units	57	1,030	211	239
Common stock warrants, exercisable at $1.665 per share	—	856	—	857
Total	57	1,886	211	1,096
Unvested antidilutive stock units excluded from the dilutive effect (stock units)	3,056	—	1,348	—

16. RELATED PARTY TRANSACTIONS

Emmett J. Wood, the brother of our Chairman and CEO, has been an employee of the Company since 1996. The amounts paid to this individual as compensation were $93,000 and $605,000 for the three and six months ended June 30, 2022, respectively, and $83,000 and $301,000 for the three and six months ended June 30, 2021, respectively. Additionally, Mr. Wood owned 94,547 and 73,562 shares of the Company's common stock as of June 30, 2022, and December 31, 2021.

One of the Company's directors serves as a consultant to the Company. In February 2022, the director and the Company amended the consulting agreement to provide that the Company would pay the remainder of the director's consulting fees for 2022 in a fixed price amount in the form of restricted stock units. The Company granted the director 26,091 restricted stock units on February 1, 2022, which vest quarterly in four equal amounts through the end of the year, subject to the director's continued performance under the consulting agreement. The amounts paid for his consulting services were $25,000 for the three and six months ended June 30, 2022, and $70,500 and $141,000 for the three and six months ended June 30, 2021, respectively.

17. SEGMENT INFORMATION

As noted in Note 2 - Significant Accounting Policies, during the fourth quarter of 2021, as a result of the segment reorganization, our CODM began evaluating, overseeing and managing the financial performance of our operations through two operating segments: Security Solutions and Secure Networks. The segments enable the alignment of our strategies and objectives and provide a framework for timely and rational allocation of resources within the lines of business. We eliminate any inter-segment revenues and expenses upon consolidation.

The Security Solutions segment is primarily focused on cybersecurity, cloud and identity solutions, and secure messaging through Xacta®, Telos Ghost®, Telos® Advanced Cyber Analytics, Telos® AMHS and Telos® ID offerings. We recognize revenue on contracts from providing various system platforms in the cloud, on-premises and in hybrid cloud environments, as well as software sales or software-as-a-service. Revenue associated with the segment's custom solutions is recognized as work progresses or upon delivery of services and products. Fluctuation in revenue from period to period is the result of the volume of software sales, and progress or completion of cloud and/or cybersecurity solutions during the period. The majority of the operating costs relates to labor, material, and overhead costs. Software sales have immaterial operation costs associated with them, thus yielding higher margins. Gross profit and margin are a function of operational efficiency on security solutions and changes in the volume of software sales.

The Secure Networks segment provides secure networking architectures and solutions to our customers through secure mobility solutions and network management and defense services. Revenue is recognized over time as the work progresses on contracts related to managing network services and information delivery. Contract costs include labor, material and overhead costs. Variances in costs recognized from period to period primarily reflect increases and decreases in activity level on individual contracts.

Table 17: Results of Operations by Business Segment

	For the Three Months Ended		For the Six Months Ended	
	June 30, 2022	June 30, 2021	June 30, 2022	June 30, 2021
	(in thousands)			
Revenues:				
Security Solutions	$ 30,819	$ 32,236	$ 57,738	$ 55,066
Secure Networks	24,972	21,408	48,213	54,336
Total revenue	55,791	53,644	105,951	109,402
Gross profit:				
Security Solutions	16,433	17,188	31,485	26,515
Secure Networks	4,496	5,346	8,315	10,489
Total gross profit	20,929	22,534	39,800	37,004
Selling, general and administrative expenses	33,095	40,005	66,700	67,969
Operating loss	(12,166)	(17,471)	(26,900)	(30,965)
Other income/(expense)	118	32	130	(1,022)
Interest expense	(187)	(192)	(377)	(388)
Loss before income taxes	(12,235)	(17,631)	(27,147)	(32,375)
Provision for income taxes	(54)	(13)	(125)	(47)
Net loss	$ (12,289)	$ (17,644)	$ (27,272)	$ (32,422)

We measure each segment's profitability based on gross profit. We account for inter-segment sales and transfers as if the sales or transfers were to third parties, that is, at current market prices. Interest income, interest expense, other income and expense items and income taxes, as reported in the consolidated financial statements, are not part of the segment profitability measure, and are primarily recorded at the corporate level. Under U.S. government Cost Accounting Standards, indirect costs including depreciation and amortization expense, are collected in numerous indirect cost pools, which are then collectively allocated out to the Company’s reportable segments based on a representative causal or beneficial relationship of the costs in the pool to the costs in the base. While depreciation and amortization expense is a component of the allocated costs, the allocation process precludes depreciation and amortization expense from being specifically identified by the Company’s individual reportable and operating segments. For this reason, the non-cash items by a reportable and operating segment have not been reported above.

Management does not utilize total assets by segment to evaluate segment performance or allocate resources. As a result, assets are not tracked by segment and therefore, total assets by segment are not disclosed.

18. REVISION OF PRIOR YEAR INTERIM FINANCIAL STATEMENTS

During the third quarter of 2021, the Company identified that stock compensation for a single individual was incorrectly charged to "cost of sales - services" instead of "general and administrative expense." The total amount of stock compensation incorrectly charged to cost of sales was $0.3 million, of which $0.1 million was related to the first quarter of 2021, and $0.2 million related to the second quarter of 2021. The Company corrected the error during the third quarter of 2021.

During the third quarter of 2021, the Company identified that the allocation of stock compensation for two of the Company's overhead cost pools was incorrectly charged to "cost of sales" instead of "general and administrative expense" during the second quarter of 2021. The total amount of the allocated stock compensation incorrectly charged to cost of sales was $0.7 million, which the Company corrected during the third quarter of 2021.

In the third quarter of 2021, the Company identified $1.1 million in revenue related to the stub period of a newly awarded contract that should have been recognized as income during the second quarter of 2021. The Company initially corrected the error during the third quarter of 2021. Additionally, and related to this contract, in the fourth quarter of 2021 the Company identified $0.3 million of products revenue for the second quarter of 2021 that should be classified in the condensed consolidated statements of operations as services revenue.

The Company erroneously presented the $2.4 million final payment to fully acquire all membership interest of Telos ID as an operating activity on the condensed consolidated statements of cash flows. The Company corrected the presentation to properly reflect the final payment within financing activities on the consolidated statements of cash flows in the fourth quarter of 2021.

Table 18.1: Impact of the Correction to the Condensed Consolidated Statement of Operations

	For the Three Months Ended June 30, 2021			For the Six Months Ended June 30, 2021		
	Previously Reported	Error Correction	As Adjusted	Previously Reported	Error Correction	As Adjusted
	(in thousands, except per share amounts)					
Revenue - services	$ 47,618	$ 1,385	$ 49,003	$ 99,676	$ 1,385	$ 101,061
Revenue - products	4,941	(300)	4,641	8,641	(300)	8,341
Revenue	52,559	1,085	53,644	108,317	1,085	109,402
Cost of sales - services	29,501	(892)	28,609	69,103	(1,004)	68,099
Costs and expenses	32,002	(892)	31,110	73,402	(1,004)	72,398
General and administrative	28,743	892	29,635	48,708	1,004	49,712
Selling, general and administrative expenses	39,113	892	40,005	66,965	1,004	67,969
Operating loss	(18,556)	1,085	(17,471)	(32,050)	1,085	(30,965)
Loss before income taxes	(18,716)	1,085	(17,631)	(33,460)	1,085	(32,375)
Net loss	(18,729)	1,085	(17,644)	(33,507)	1,085	(32,422)
Net loss attributable to Telos Corporation	(18,729)	1,085	(17,644)	(33,507)	1,085	(32,422)
Net loss per share attributable to Telos Corporation						
Basic	$ (0.28)	$ 0.02	$ (0.26)	$ (0.51)	$ 0.02	$ (0.49)
Diluted	$ (0.28)	$ 0.02	$ (0.26)	$ (0.51)	$ 0.02	$ (0.49)

Table 18.2: Impact of the Correction to the Condensed Consolidated Statement of Comprehensive Loss

	For the Three Months Ended June 30, 2021			For the Six Months Ended June 30, 2021		
	Previously Reported	Error Correction	As Adjusted	Previously Reported	Error Correction	As Adjusted
	(in thousands)					
Net loss	$ (18,729)	$ 1,085	$ (17,644)	$ (33,507)	$ 1,085	$ (32,422)
Comprehensive loss attributable to Telos Corporation	(18,724)	1,085	(17,639)	(33,534)	1,085	(32,449)

Table 18.3. Impact of the Correction to the Condensed Consolidated Statement of Cash Flows

	For the Six Months Ended June 30, 2021		
	Previously Reported	Error Correction	As Adjusted
	(in thousands)		
Net loss	$ (33,507)	$ 1,085	(32,422)
Changes in other operating assets and liabilities	(10,074)	1,351	(8,723)
Cash used in operating activities	(5,790)	2,436	(3,354)
Distribution to Telos ID Class B member – non-controlling interest	—	(2,436)	(2,436)
Cash provided by financing activities	35,474	(2,436)	33,038

Table 18.4. Impact of the Correction to the Condensed Consolidated Statement of Changes in Stockholders' Equity

	For the Three Months Ended June 30, 2021			For the Six Months Ended June 30, 2021		
	Previously Reported	Error Correction	As Adjusted	Previously Reported	Error Correction	As Adjusted
	(in thousands)					
Net loss	$ (18,729)	$ 1,085	$ (17,644)	$ (33,507)	$ 1,085	$ (32,422)
Accumulated deficit	(177,350)	1,085	(176,265)	(177,350)	1,085	(176,265)
Total Stockholders' equity	164,700	1,085	165,785	164,700	1,085	165,785

19. COMMITMENT AND CONTINGENCIES

Legal Proceedings

On February 7, 2022, Telos and certain of its current and former officers were named as defendants in a lawsuit filed in the United States District Court for the Eastern District of Virginia. In the complaint, the plaintiffs, who purport to represent a class of purchasers of Telos common stock between November 19, 2020, and March 16, 2022, allege that the defendants violated securities laws by failing to disclose delays relating to the launch of certain contracts between Telos and the Transportation Security Administration ("TSA") and the Centers for Medicare and Medicaid Services and to take into account those delays when providing a financial forecast for the Company's 2021 performance. On June 15, 2022, the Plaintiffs filed a consolidated complaint which added claims (i) concerning Telos' disclosure of revenue projections for these contracts, (ii) against the directors of Telos at the time of its initial public offering, and (iii) pursuant to Sections 11 and 15 of the Securities Act of 1933. The Company is vigorously defending the case, but given the early stage, although a loss may reasonably be possible, the Company is unable to predict the likelihood of success of plaintiffs' claims or estimate a loss or range of loss. As a result, no material liability has been recorded as of June 30, 2022 and December, 31, 2021, respectively.

In addition, the Company is a party to litigation arising in the ordinary course of business. In the opinion of management, while the results of such litigation cannot be predicted with any reasonable degree of certainty, the final outcome of such known matters will not, based upon all available information, have a material adverse effect on the Company's unaudited consolidated financial position, results of operations or cash flows.

Other - Government Contracts

As a U.S. government contractor, we are subject to various audits and investigations by the U.S. government to determine whether our operations are being conducted in accordance with applicable regulatory requirements. U.S. government investigations of our operations, whether relating to government contracts or conducted for other reasons, could result in administrative, civil, or criminal liabilities, including repayments, fines or penalties being imposed upon us, suspension, proposed debarment, debarment from eligibility for future U.S. government contracting, or suspension of export privileges. Suspension or debarment could have a material adverse effect on us because of our dependence on contracts with the U.S. government. U.S. government investigations often take years to complete, and many result in no adverse action against us. We also provide products and services to customers outside of the United States, which are subject to U.S. and foreign laws and regulations and foreign procurement policies and practices. Our compliance with local regulations or applicable U.S. government regulations also may be audited or investigated.

20. SUPPLEMENTAL CASH FLOW INFORMATION

Table 20.1: Details of Cash, Cash Equivalent, and Restricted Cash

	June 30, 2022	December 31, 2021
	(in thousands)	
Cash and cash equivalents	$ 122,588	$ 126,562
Restricted cash [1]	132	—
Cash, cash equivalents, and restricted cash	$ 122,720	$ 126,562

(1) Restricted cash consists of a commercial money market account held as a deposit on the Ashburn lease and is recorded under "Other assets" on the Consolidated Balance Sheets

Table 20.2: Supplemental Cash Flow Information

	For the Six Months Ended	
	June 30, 2022	June 30, 2021
	(in thousands)	
Cash paid during the period for:		
Interest	$ 353	$ 388
Income taxes	188	54
Non-cash investing and financing activities:		
Operating lease ROU assets obtained in exchange for operating lease liabilities	282	322
Capital expenditure activity in accounts payable and other accrued liabilities	296	—
Common stock repurchase under SRP	400	—

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

Forward-Looking Statements

This Quarterly Report on Form 10-Q contains forward-looking statements. For this purpose, any statements contained herein that are not statements of historical fact may be deemed to be forward-looking statements. Without limiting the foregoing, the words “believes,” “anticipates,” “plans,” “expects” and similar expressions are intended to identify forward-looking statements. There are a number of important factors that could cause the Company's actual results to differ materially from those indicated by such forward-looking statements. These factors include, without limitation, those set forth in the risk factors section included in the Company's Form 10-K for the year ended December 31, 2021, as filed with the SEC.

General and Business Overview

We offer technologically advanced, software-based security solutions that empower and protect the world's most security-conscious organizations against rapidly evolving, sophisticated and pervasive threats. Our portfolio of security products, services, and expertise empower our customers with capabilities to reach new markets, serve their stakeholders more effectively, and successfully defend the nation or their enterprise. We protect our customers' people, information, and digital assets so they can pursue their corporate goals and conduct their global missions with confidence in their security and privacy.

Our mission is to protect our customers' people, systems, and vital information assets with offerings for cybersecurity, cloud security, and enterprise security. In the current global environment, our mission is more critical than ever. The emergence of each new information and communications technology introduces new vulnerabilities, as security is still too often overlooked in solution development. Networks and applications meant to enhance productivity and profitability often jeopardize an organization due to poor planning, misconfiguration, or an unknown gap in security. Ransomware, insider threats, cybercrime, and advanced persistent threats continue to menace public and private enterprises across all industries.

Cybersecurity, cloud security, and enterprise security of the modern organization share much in common, yet also call for a diverse range of skills, capabilities, and experience in order to meet the requirements of security-conscious customers. Decades of experience in developing, orchestrating, and delivering solutions across these three domains give us the vision and the confidence to provide solutions that empower and protect the enterprise at an integrated, holistic level. Our experience in addressing challenges in one area of an enterprise helps us meet requirements in others. We understand that a range of complementary capabilities may be needed to solve a single challenge, and we also recognize when a single solution might address multiple challenges. Our security solutions span across the following domains: cybersecurity, cloud security, and enterprise security.

As a result of the change in our organization and leadership structure in the fourth quarter of 2021, we established and operate in two reportable segments – Security Solutions and Secure Networks.

Security Solutions

Security Solutions focuses on cybersecurity, cloud and identity solutions, which includes Information Assurance, Secure Communications, and Telos ID. Cybersecurity solutions help our customers ensure the ongoing security, integrity, and compliance of their on-premises and related cloud-based systems by reducing threats and vulnerabilities to foil cyber adversaries before they can attack. Our security engineers and subject matter experts assess our customers' cybersecurity environments and design, engineer, and operate systems needed to strengthen their cybersecurity posture. Our cloud solutions leverage the specialized skills and experience needed to help our customers plan, engineer, execute and accelerate secure cloud migrations while assuring ongoing management and security of enterprise cloud technology environments. Our identity solutions deliver digital identity, biometric, and nationwide enrollment services and address Know Your Customer ("KYC") and identity management challenges for enterprises working within regulated and critical infrastructure environments.

- ***Information Assurance***
    - *Xacta*: a premier platform for enterprise cyber risk management and security compliance automation, delivering security awareness for systems in the cloud, on-premises, and in hybrid and multi-cloud environments. Xacta delivers automated cyber risk and compliance management solutions to large commercial and government enterprises. Across the U.S. federal government, Xacta is the de facto commercial cyber risk and compliance management solution.
    - *Telos Advanced Cyber Analytics ("ACA")*: a solution-as-a-service that delivers timely, accurate, actionable intelligence at speed and scale to illuminate threats to enterprise assets. It enables organizations to detect malicious activity earlier and to uncover and identify previously unknown attacks and new malicious behavior. Further, it assists in the attribution of events and provides sophisticated and comprehensive analytics without expensive overhead.

- ***Secure Communications:***
    - *Telos Ghost:* a virtual obfuscation network-as-a-service with encryption and managed attribution capabilities to ensure the safety and privacy of people, information, and resources on the network. Telos Ghost seeks to eliminate cyberattack surfaces by obfuscating and encrypting data, masking user identity and location, and hiding network resources. It provides the additional layers of security and privacy needed for intelligence gathering, cyber threat protection, securing critical infrastructure, and protecting communications and applications when operations, property, and even lives can be jeopardized by a single error in security.
    - *Telos Automated Message Handling System ("AMHS"):* web-based organizational message distribution and management for mission-critical communications; the recognized gold standard for organizational messaging in the U.S. government. Telos AMHS is used by military field operatives for critical communications on the battlefield and is the only web-based solution for assured messaging and directory services using the Defense Information System Agency's Organizational Messaging Service and its specialized communications protocols.
- ***Telos ID:*** offering identity trust and digital services through IDTrust360® – an enterprise-class digital identity risk platform for extending flexible hybrid cloud identity services enabled for mobile and enterprise environments and custom digital identity services that mitigate threats through the integration of advanced technologies that fuse biometrics, credentials, and other identity-centric data used to continuously monitor trust. In April 2021, we announced the acquisition of the assets of DFT, whose ONYX® touchless mobile fingerprint software is being integrated with the IDTrust360 platform. We maintain government certifications and designations that distinguish Telos ID, including TSA PreCheck® enrollment provider, Designated Aviation Channeling provider, FBI-approved Channeler, and Financial Industry Regulatory Authority Electronic Fingerprint Submission provider.

Secure Networks

Secure Networks focuses on enterprise security. Secure Networks provides secure networking architectures and solutions to the DoD, the federal Intelligence Community and other federal government agencies. Our net-centric solutions enable collaboration and connectivity in order to increase efficiency, reduce costs, and improve mission outcomes. We provide an extensive range of wired and wireless, fixed and deployable, classified and unclassified voice, data, and video secure network solutions and services to support defense and civilian missions. Capabilities include network design, operations and sustainment; system integration and engineering; network security and compliance; deployable comms; innovation and digital transformation; service desk; defensive cyber operations; and program management.

- ***Secure Mobility:*** solutions for business and government that enable remote work and minimize operational and security concerns across and beyond the enterprise. Our secure mobility team brings credentials to every engagement, supplying deep expertise and experience as well as highly desirable clearances and industry-recognized certifications for network engineering, mobility, and security.
- ***Network Management and Defense:*** services for operating, administrating, and defending complex enterprise networks and defensive cyber operations. Our diverse portfolio of capabilities such as defensive cyber operations and robotic process automation addresses common and uncommon requirements in many industries and disciplines, ranging from the military and government agencies to Fortune 500 companies.

Business Environment

Our business performance continues to be heavily affected by the overall level of U.S. government spending and the alignment of our solutions with the priorities of the U.S. government. U.S. government spending and contracts continue to be affected by the federal budget and appropriations process and related legislation.

Congress reached an agreement in March 2022 on fiscal year ("FY") 2022 appropriations legislation, which allows our federal customers to finally operate under more normal conditions and with updated funding levels through the remainder of FY 2022. Of note, the final FY 2022 appropriations bill provided $728.5 billion for the DoD and related activities. This amount is $32.5 billion more than the FY 2021 enacted level, and is an increase above the level proposed last spring by President Biden for FY 2022. This total does not include emergency supplemental appropriations enacted to deal with impacts from the Ukraine conflict, which further increased total defense spending this year.

Given the current political climate in Washington, it is highly questionable whether Congress will be able to enact FY 2023 appropriations legislation prior to the start of the fiscal year. This could again result in the need to fund much, if not all, of the federal government via continuing resolution(s) for an unknown length of time, or else face a government shutdown. Such delays in finalizing FY 2023 appropriations could, in turn, impact future planning by Telos and our government customers.

The President’s FY 2023 budget request, which was released on March 25, 2022, calls for approximately 4% more in defense spending than was provided for FY 2022. However, this proposed FY 2023 budget was developed prior to Russia’s invasion of Ukraine and did not include expenditures related to that ongoing event. The proposed FY 2023 budget also assumes an inflation rate for DoD of 2.2%, which Pentagon officials subsequently acknowledged will need to be adjusted higher. As such, there is significant congressional support for boosting defense spending further to account for these factors and other needs. The House and Senate versions of the FY 2023 National Defense Authorization Act reflect this, authorizing appropriations of $37 billion (House) and $45 billion (Senate) more than proposed by the President’s budget. Actual final appropriations levels for national defense will not be determined until this fall, at the earliest.

The proposed FY 2023 budget also calls for an increase in federal civilian agency (non-defense) cybersecurity funding of nearly 10.7%. The Biden Administration says it is seeking to increase investments across the various civilian federal agencies to help align them to the cybersecurity practices and priorities outlined in the President’s Executive Order 14028, “Improving the Nation’s Cybersecurity.” The proposed budget says this specifically includes providing funding to facilitate the ongoing transition to a Zero Trust approach to cybersecurity, per the direction of President Biden's May 12, 2021 Executive Order on "Improving the Nation's Cybersecurity." Also in accordance with that order, various federal departments and agencies have been taking steps to enhance public sector and critical infrastructure cybersecurity and to accelerate the adoption of Zero Trust architecture throughout government, and the proposed budget would further support those efforts. Congress has just begun work on the FY 2023 appropriations bills for civilian agencies, so it is unknown what the final funding levels will be for civilian agency cybersecurity.

Cybersecurity Landscape

Over the past few years, continued and increasingly damaging ransomware and other cyberattacks against federal, state and local governments, the K-12 and higher education sectors, and private sector enterprises have resulted in intensified efforts to better defend against such attacks. The growing demand for these solutions continues to provide Telos with the privilege of offering our expertise to protect these vitally important organizations.

Ransomware remains arguably the most severe cyber threat to enterprises in the commercial and state, local government and education sectors. Our Xacta offering empowers these organizations and institutions to maintain a strong cyber risk posture to minimize the risk of ransomware gaining a foothold in their IT environment. Our Telos ACA offering provides real- and near-real-time intelligence into known and unknown threats to give organizations advanced warning of ransomware and other threats. Should ransomware get loose in the enterprise network, Telos Ghost, our virtual obfuscation network offering, can hide vital resources from view to prevent the payload from reaching them.

Critical infrastructure and industrial internet of things ("IoT") are among the categories at greatest risk of cyberattacks. Energy, utilities, transportation, and food supply were among the critical infrastructure sectors that experienced high-profile breaches or ransomware attacks over the past year. Telos Ghost can hide critical IoT and industrial control systems from the public internet to keep them from being compromised. Telos Ghost can also cordon off financial data, medical records, intellectual property, and other crown-jewel assets from visibility or accessibility by adversaries.

Telos Ghost complements Zero Trust security, creating an additional layer of defense against intruders by hiding critical resources and users in an anonymous undiscoverable network. As noted above, it protects the crown-jewel assets of critical infrastructure from unauthorized access. Xacta streamlines and automates the critical processes of the leading cybersecurity standards and frameworks, particularly the Federal Risk and Authorization Management Program ("FedRAMP"), allowing all process participants to collaborate within the same Xacta application to attain a FedRAMP Authority to Operate. Xacta is also a trailblazer in adopting the Open Security Controls Assessment Language, a multi-format framework adopted by FedRAMP to allow security professionals to automate security assessment, auditing, and continuous monitoring processes.

The Cyber Incident Reporting for Critical Infrastructure Act of 2022, which was signed into law on March 15, 2022, will require critical infrastructure owners and operators as well as federal agencies to report to the Cybersecurity & Infrastructure Security Agency significant cyber incidents within 72 hours and any ransomware payments made within 24 hours. Telos believes that having to make such disclosures will make organizations even more sensitive to boosting their cybersecurity posture; our Xacta solution will help illuminate their risk profile and our Telos ACA solution will illuminate threats so that they can better understand the issues and address them proactively.

The Securities and Exchange Commission has also proposed new, mandatory cyber risk management and cybersecurity incident reporting requirements for publicly traded companies. Telos believes this will ensure companies take steps to employ a sound cyber risk management strategy based on recognized best practices, such as the National Institute of Standards and Technology Cybersecurity Framework, and Telos solutions will support this.

Government mandates and initiatives to assure stronger security in highly regulated industries, as noted above, also lead to opportunities for Xacta. An update to the research study Telos conducted last year reveals that audit fatigue continues to burden these organizations, with automation solutions being recognized as the most effective remedy for the many repetitive and redundant tasks that security compliance requires. Xacta streamlines, harmonizes, and automates the security controls and processes that comprise the leading cybersecurity standards and frameworks, in on-premises, cloud, hybrid, and multi-cloud environments.

COVID-19 Pandemic

Despite the pandemic's resultant shift to teleworking by federal employees and contractors, the government successfully maintained the continuity of services, as did Telos. As the government has developed and implemented its reopening process, and made adjustments based on changing circumstances, officials have said they will seek to continue to maximize the use of teleworking by federal employees. This stance has continued during subsequent surges of COVID-19 variants. As such, with much of the business of government still being conducted by federal employees working remotely through the use of information technology systems, we believe there will continue to be a need on the part of the government for the types of solutions and services provided by Telos.

Backlog

We develop our annual budgeted revenue by estimating for the upcoming year our continuing business from existing customers and active contracts. We consider backlog, both funded and unfunded (as explained below), other expected annual renewals, and expansion planned by our current customers.

Total backlog consists of the aggregate contract revenues remaining to be earned by us at a given time over the life of our contracts, whether funded or unfunded. Funded backlog consists of the aggregate contract revenues remaining to be earned at a given time, which, in the case of U.S. government contracts, means that they have been funded by the procuring agency. Unfunded backlog is the difference between total backlog and funded backlog and includes potential revenues that may be earned if customers exercise delivery orders and/or renewal options to continue these contracts. Based on historical experience, we generally assume option year renewals to be exercised. Most of our customers fund contracts on a basis of one year or less and, as a result, funded backlog is generally expected to be earned within one year from any point in time, whereas unfunded backlog is expected to be earned over a longer period.

Results of Operations

Table MD&A 1: Results of Operations

	For the Three Months Ended		For the Six Months Ended	
	June 30, 2022	June 30, 2021	June 30, 2022	June 30, 2021
		(in thousands)		
Revenue	$ 55,791	53,644	105,951	109,402
Cost of sales	34,862	31,110	66,151	72,398
Gross profit	20,929	22,534	39,800	37,004
Gross margin	***37.5 %***	***42.0 %***	***37.6 %***	***33.8 %***
Selling, general and administrative expenses:				
Sales and marketing	4,741	5,043	9,993	8,869
Research and development	4,489	5,327	9,919	9,388
General and administrative	23,865	29,635	46,788	49,712
Total selling, general and administrative expenses	33,095	40,005	66,700	67,969
Selling, general and administrative expenses as percentage of revenue	***59.3 %***	***74.6 %***	***63.0 %***	***62.1 %***
Operating loss	(12,166)	(17,471)	(26,900)	(30,965)
Other income/(expense)	118	32	130	(1,022)
Interest expense	(187)	(192)	(377)	(388)
Loss before income taxes	(12,235)	(17,631)	(27,147)	(32,375)
Provision for income taxes	(54)	(13)	(125)	(47)
Net loss	$ (12,289)	$ (17,644)	$ (27,272)	$ (32,422)

Company Results

We generate revenue from the delivery of product and services to our customers. The discussion of material changes in our net revenue should be read in conjunction with the subsequent discussion of changes in our consolidated cost of sales and our business segment results of operations. Cost of sales, for both services and products, consists of material, labor, subcontracting costs and an allocation of indirect costs.

Three Months Ended June 30, 2022 Compared with Three Months Ended June 30, 2021

Revenue increased by 4.0% to $55.8 million for the second quarter of 2022, from $53.6 million for the same period in 2021. Services revenue increased by $1.3 million, or 2.6%, during the second quarter of 2022 compared to the same period in 2021. The increase in services revenue was primarily due to sales offerings within Secure Networks. Product revenue increased $0.9 million, or 19.0%, during the second quarter of 2022 compared to the same period in 2021. The increase in product revenue was primarily due to various product delivery within Security Solutions. Due to the various solution offerings within the business groups, sales may vary from period to period according to the solution mix and timing of deliverables for a particular period.

Cost of sales increased by 12.1% to $34.9 million for the second quarter of 2022, from $31.1 million for the same period in 2021, as a result of increased revenue. The change in cost of sales is directly driven by the change in mix and nature of the programs. Cost of sales for Security Solutions decreased to $14.4 million for the second quarter of 2022 from $15.0 million for the same period in 2021. While the cost of sales decreased between periods, the cost of sales as a percentage of revenue remained at 46.7%. Cost of sales for Secure Networks increased to $20.5 million for the second quarter of 2022 from $16.1 million for the same period in 2021. Likewise, cost of sales as a percentage of revenue increased to 82.0% from 75.0%.

Gross profit decreased by 7.1% to $20.9 million for the second quarter of 2022 from $22.5 million for the same period in 2021. Gross margin decreased to 37.5% for the second quarter of 2022 from 42.0% for the same period in 2021, due to various changes in the mix of contracts within each of Security Solutions and Secure Networks, as well as the relative weighting of revenue between these segments.

Selling, general, and administrative (“SG&A”) expense decreased by 17.3% to $33.1 million for the second quarter of 2022, from $40.0 million for the same period in 2021, primarily attributable to a decrease in stock-based compensation by $6.6 million, offset by an increase in labor costs by $0.5 million.

Operating loss was $12.2 million for the second quarter of 2022, compared to $17.5 million for the same period in 2021, primarily due to a decrease in SG&A expenses partially offset by a decrease in gross profit in the second quarter of 2022 as mentioned above.

There were no significant changes in interest expense, and other income and expenses between the comparable periods.

The slight increase in the income tax provision for the second quarter of 2022 compared to the same period in 2021 is based on the estimated annual effective tax rate applied to the pretax loss incurred for the quarter plus discrete tax items, based on our expectation of pretax loss for the fiscal year.

Net loss was $12.3 million for the second quarter of 2022, compared to $17.6 million for the same period in 2021, primarily due to a decrease in SG&A expenses partially offset by a decrease in gross profit in the second quarter of 2022 as mentioned above.

Six Months Ended June 30, 2022 Compared with Six Months Ended June 30, 2021

Revenue decreased by 3.2% to $106.0 million during the six months ended June 30, 2022, from $109.4 million for the same period in 2021. Services revenue decreased by $2.7 million, or 2.7%, during the six months ended June 30, 2022 compared to the same period in 2021. Product revenue also decreased by $0.8 million, or 9.2%, during the six months ended June 30, 2022 compared to the same period in 2021. The decrease in revenue was attributable to the impact of certain projects nearing their completion within Secure Networks.

Cost of sales decreased by 8.6% to $66.2 million for the six months ended June 30, 2022, from $72.4 million for the same period in 2021. Cost of sales for Security Solutions decreased to $26.3 million for the six months ended June 30, 2022, from $28.6 million for the same period in 2021. In addition, cost of sales as a percentage of revenue decreased to 45.5% from 51.8%. Cost of sales for Secure Networks decreased to $39.9 million for the six months ended June 30, 2022 from $43.8 million for the same period in 2021. While the costs of sales decreased between periods, the cost of sales as a percentage of revenue increased to 82.8% from 80.7%. The overall decrease in cost of sales was due to various changes in the mix of contracts within each of Security Solutions and Secure Networks, and winding down of lower-margin projects.

Gross profit increased by 7.6% to $39.8 million for the six months ended June 30, 2022, from $37.0 million for the same period in 2021. Gross margin increased to 37.6% for the six months ended June 30, 2022 from 33.8% for the same period in 2021, due to a change in the mix of contracts within each of Security Solutions and Secure Networks, as well as the relative weighting of revenue between Security Solutions and Secure Networks.

SG&A expense decreased by 1.9% to $66.7 million for the six months ended June 30, 2022, from $68.0 million for the same period in 2021, primarily attributable to a decrease in stock-based compensation by $7.0 million, offset by the increases in labor costs by $4.8 million and outside services by $0.9 million.

Operating loss was $26.9 million for the six months ended June 30, 2022, compared to $31.0 million for the same period in 2021, primarily due to the increase in gross profit and decrease in SG&A expenses in 2022 compared with the same period in the prior year as mentioned above.

Other expense of $1.0 million for the six months ended June 30, 2021, was attributable to an accrual for a litigation settlement agreement, with no similar cost in 2022. There was no significant change in interest expense between comparable periods.

The slight increase in the income tax provision for the six months ended June 30, 2022 compared to the same period in 2021 is based on the estimated annual effective tax rate applied to the pretax loss incurred for the six months period plus discrete tax items, based on our expectation of pretax loss for the fiscal year.

Net loss was $27.3 million for the six months ended June 30, 2022, compared to $32.4 million for the same period in 2021, primarily attributable to the increase in gross profit and decreases in certain SG&A and other expenses as mentioned above.

Segment Results

The accounting policies of each business segment are the same as those followed by the Company as a whole. Management evaluates business segment performance based on gross profit.

Table MD&A 2: Security Solutions Segment - Financial Results

	For the Three Months Ended		For the Six Months Ended	
	June 30, 2022	June 30, 2021	June 30, 2022	June 30, 2021
	(in thousands)			
Revenue	$ 30,819	$ 32,236	$ 57,738	$ 55,066
Gross profit	$ 16,433	$ 17,188	$ 31,485	$ 26,515
Gross margin	53 %	53 %	55 %	48 %

For the three months ended June 30, 2022, Security Solutions' revenue decreased by approximately 4% compared to the same period in 2021. This was driven primarily by a decrease of $2.3 million in services revenue, offset by an increase of $0.9 million in product revenue compared to the same period in 2021. This is primarily due to the decrease in sales offerings for certain projects winding down within the segment's business lines.

Revenue for the six months ended June 30, 2022 increased by approximately 5%, which was primarily driven by an increase of $3.4 million in services revenue compared to the same period in 2021, due to an increase in sales offerings within the segment.

Security Solutions' gross profit for the second quarter of 2022 decreased by $0.8 million or 4% compared to the same period in 2021. With revenue decreased, segment gross margin remained at 53% between comparable periods.

Security Solutions' gross profit for the six months ended June 30, 2022 increased by $5.0 million or 19% compared to the same period in 2021. Likewise, segment gross margin increased to 55% for the six months ended June 30, 2022 from 48% for the same period in 2021. The increase in profitability was due to growth in high margin projects under this segment.

Table MD&A 3: Secure Networks Segment - Financial Results

	For the Three Months Ended		For the Six Months Ended	
	June 30, 2022	June 30, 2021	June 30, 2022	June 30, 2021
	(in thousands)			
Revenue	$ 24,972	$ 21,408	$ 48,213	$ 54,336
Gross profit	$ 4,496	$ 5,346	$ 8,315	$ 10,489
Gross margin	18 %	25 %	17 %	19 %

Secure Networks' revenue for the second quarter of 2022 increased by approximately 17% compared to the same period in 2021. This was driven by an increase of $3.6 million in service revenue due to new awards, timing of significant orders and higher segment offerings on several existing projects.

For the six months ended June 30, 2022, Secure Networks' revenue decreased by 11% compared to the same period in 2021. This was primarily due to the ramping down of certain large projects under our Secure Networks offerings.

Secure Networks' gross profit for the second quarter of 2022, decreased by $0.9 million or 16% compared to the same period in 2021. Segment gross margin decreased to 18% for the second quarter of 2022 from 25% for the same period in 2021. This is due to the various changes in the mix of contracts within the segment and timing of order delivery.

Gross profit for Secure Networks for the six months ended June 30, 2022 decreased by $2.2 million or 21% compared to the same period in 2021, as a result of the decline in year-to-date segment revenue. Secure Networks' gross margin also decreased to 17% for the for the six months ended 2022 from 19% compared to the same period in 2021 due to the sale mix.

Non-GAAP Financial Measures

In addition to our results determined in accordance with GAAP, we believe the non-GAAP financial measures of Enterprise EBITDA, Adjusted EBITDA, Adjusted Net Income (Loss), Adjusted Earnings Per Share ("EPS") and Free Cash Flow are useful in evaluating our operating performance. We believe that this non-GAAP financial information, when taken collectively with our GAAP results, may be helpful to readers of our financial statements because it provides consistency and comparability with past financial performance and assists in comparisons with other companies, some of which use similar non-GAAP financial information to supplement their GAAP results. The non-GAAP financial information is presented for supplemental informational purposes only, should not be considered a substitute for financial information presented in accordance with GAAP, and may be different from similarly titled non-GAAP measures used by other companies. A reconciliation is provided below for each of these non-GAAP financial measures to the most directly comparable financial measure stated in accordance with GAAP.

We use the following non-GAAP financial measures to understand and evaluate our core operating performance and trends, to prepare and approve our annual budget, to develop short-term and long-term operating plans, and to evaluate the performance of certain management personnel when determining incentive compensation. We believe these non-GAAP financial measures facilitate comparison of our operating performance on a consistent basis between periods by excluding certain items that may, or could, have a disproportionately positive or negative impact on our results of operations in any particular period. When viewed in combination with our results prepared in accordance with GAAP, these non-GAAP financial measures help provide a broader picture of factors and trends affecting our results of operations.

Enterprise EBITDA and Adjusted EBITDA

Both Enterprise EBITDA and Adjusted EBITDA are supplemental measures of operating performance that are not made under GAAP and that do not represent, and should not be considered as, an alternative to net (loss) income as determined by GAAP. We define Enterprise EBITDA as net (loss) income, adjusted for non-operating expense (income), interest expense, provision for (benefit from) income taxes, and depreciation and amortization. We define Adjusted EBITDA as Enterprise EBITDA, adjusted for stock-based compensation expense.

Table MD&A 4: Reconciliation of Net Loss to Enterprise EBITDA and Adjusted EBITDA

	For the Three Months Ended		For the Six Months Ended	
	June 30, 2022	June 30, 2021	June 30, 2022	June 30, 2021
	(in thousands)			
Net loss	$ (12,289)	$ (17,644)	$ (27,272)	$ (32,422)
Adjustments:				
Non-operating (income)/expense	(118)	(32)	(130)	1,022
Interest expense	187	192	377	388
Provision for income taxes	54	13	125	47
Depreciation and amortization	1,505	1,404	2,910	2,764
Enterprise EBITDA	(10,661)	(16,067)	(23,990)	(28,201)
Stock-based compensation expense [(1)]	15,206	21,336	29,504	35,006
Adjusted EBITDA	$ 4,545	$ 5,269	$ 5,514	$ 6,805

(1) The stock-based compensation adjustment to EBITDA for the three and six months ended June 30, 2022, is made up of $14.6 million and $27.2 million of stock-based compensation expenses for the awarded RSUs and PRSUs, respectively, and $0.7 million and $2.3 million of other sources of stock-based compensation expense, respectively. The other source of stock-based compensation consist of accrued compensation, which the Company intends to settle in shares of the Company's common stock. However, it is the Company's discretion whether this compensation will ultimately be paid in stock or cash. The Company has the right to dictate the form of these payments up until the date at which they are paid. Any change to the expected payment form would result in out of quarter adjustments to this add back to Adjusted EBITDA.

Adjusted Net Income (Loss) and Adjusted EPS

Adjusted Net Income (Loss) and Adjusted EPS are supplemental measures of operating performance that are not made under GAAP and that do not represent, and should not be considered as, alternatives to net income (loss) as determined by GAAP. We define Adjusted Net Income (Loss) as net income (loss), adjusted for non-operating expense (income) and stock-based compensation expense. We define Adjusted EPS as Adjusted Net Income (Loss) divided by the weighted-average number of common shares outstanding for the period.

Table MD&A 5: Reconciliation of Net Loss to Adjusted Net Income and Adjusted EPS

	For the Three Months Ended				For the Six Months Ended			
	June 30, 2022		June 30, 2021		June 30, 2022		June 30, 2021	
	Adjusted Net Income/(Loss)	Adjusted Per Share	Adjusted Net Income/(Loss)	Adjusted Per Share	Adjusted Net Income/(Loss)	Adjusted Per Share	Adjusted Net Income/(Loss)	Adjusted Per Share
	(in thousands, except per share data)							
Reported GAAP measure	$ (12,289)	$ (0.18)	$ (17,644)	$ (0.26)	$ (27,272)	$ (0.40)	$ (32,422)	$ (0.49)
Adjustments:								
Non-operating (income)/ expense	(118)	—	(32)	—	(130)	—	1,022	0.02
Stock-based compensation expense (2)	15,206	0.22	21,336	0.32	29,504	0.43	35,006	0.53
Adjusted non-GAAP measure	$ 2,799	$ 0.04	$ 3,660	$ 0.06	$ 2,102	$ 0.03	$ 3,606	$ 0.06
Weighted-average shares of common stock outstanding	67,876		66,616		67,717		65,621	

(2) The stock-based compensation adjustment to net loss for the three and six months ended June 30, 2022, is made up of $14.6 million and $27.2 million of stock-based compensation expense for the awarded RSUs and PRSUs, respectively, and $0.7 million and $2.3 million of other sources of stock-based compensation expense, respectively. The other source of stock-based compensation consist of accrued compensation, which the Company intends to settle in shares of the Company's common stock. However, it is the Company's discretion whether this compensation will ultimately be paid in stock or cash. The Company has the right to dictate the form of these payments up until the date at which they are paid. Any change to the expected payment form would result in out-of-quarter adjustments to this add back to Adjusted Net Income/(Loss).

Free Cash Flow

Free cash flow, as reconciled in the table below, is a non-GAAP financial measure defined as net cash provided by or used in operating activities, less purchases of property and equipment and capitalized software development costs. This non-GAAP financial measure may be a useful measure for investors and other users of our financial statements as a supplemental measure of our cash performance and to assess the quality of our earnings as a key performance measure in evaluating management.

Table MD&A 6: Free Cash Flow

	For the Three Months Ended		For the Six Months Ended	
	June 30, 2022	June 30, 2021	June 30, 2022	June 30, 2021
	(in thousands)			
Net cash flows provided by/(used in) operating activities	$ 7,883	$ 3,528	$ 8,132	$ (3,354)
Adjustments:				
Purchase of property and equipment	(95)	(590)	(641)	(1,070)
Capitalized software development costs	(2,339)	(1,498)	(5,134)	(3,663)
Free cash flow	$ 5,449	$ 1,440	$ 2,357	$ (8,087)

Each of Enterprise EBITDA, Adjusted EBITDA, Adjusted Net Income (Loss), Adjusted EPS and Free Cash Flow has limitations as an analytical tool, and you should not consider any of them in isolation, or as a substitute for analysis of our results as reported under GAAP. Among other limitations, each of Enterprise EBITDA, Adjusted EBITDA, Adjusted Net Income (Loss), Adjusted EPS and Free Cash Flow does not reflect our cash expenditures, or future requirements, for capital expenditures or contractual commitments, does not reflect the impact of certain cash charges resulting from matters we consider not to be indicative of our ongoing operations, and does not reflect income tax expense or benefit. Other companies in our industry may calculate Enterprise EBITDA, Adjusted EBITDA, Adjusted Net Income (Loss), Adjusted EPS and Free Cash Flow differently than we do, which limits their usefulness as a comparative measure. Because of these limitations, neither Enterprise EBITDA, Adjusted EBITDA, Adjusted Net Income (Loss), Adjusted EPS nor Free Cash Flow should be considered as a replacement for net income (loss), earnings per share, or net cash flows provided by/ (used in) operating activities, as determined by GAAP, or as a measure of our profitability. We compensate for these limitations by relying primarily on our GAAP results and using non-GAAP measures only for supplemental purposes.

Liquidity and Capital Resources

Upon the closing of the IPO in November 2020, we issued 17.2 million shares of our common stock at a price of $17.00 per share, generating net proceeds of approximately $272.8 million. We used approximately $108.9 million of the net proceeds in connection with the exchangeable redeemable preferred stock conversion, $30.0 million to fund our acquisition of the outstanding Class B Units of Telos ID (see Note 10 – Purchase of Telos ID Non-controlling Interests), and $21.0 million to repay our outstanding senior term loan and subordinated debt .

On April 6, 2021, we completed our follow-on offering of 9.1 million shares of our common stock at a price of $33.00 per share, including 7.0 million shares of common stock by certain existing stockholders of Telos. The offering generated approximately $64.3 million of net proceeds to Telos. We did not receive any proceeds from the shares of common stock sold by the selling stockholders. On April 19, 2021, we used approximately $1.3 million of the net proceeds to repurchase 39,682 shares of our common stock and $26.9 million to repurchase 900,970 outstanding warrants for our common stock held by EnCap fund holders. Further, on July 30, 2021, we used approximately $5.9 million of the net proceeds to acquire the assets of DFT (see Note 9 – Acquisition). We intend to use the remaining net proceeds of the IPO and the follow-on offering for general corporate purposes.

Our overall financial position and liquidity are strong. Our working capital was $130.4 million and $140.8 million as of June 30, 2022, and December 31, 2021, respectively. Although no assurances can be given, we expect that funds generated from operations are sufficient to maintain the liquidity we require to meet our operating, investing and financing needs for the next 12 months.

As of June 30, 2022, we had a cash and cash equivalent balance of $122.6 million, compared to $126.6 million at December 31, 2021. This balance gives us the flexibility for capital deployment while maintaining our focus on preserving a strong balance sheet to position us for future opportunities. We believe we have adequate funds on hand to execute our financial and operating strategy.

Cash provided by operating activities was $8.1 million for the six months ended June 30, 2022, compared to cash used in operating activities of $3.4 million for the same period in 2021. Cash provided by or used in operating activities is primarily driven by the Company's operating income (loss), the timing of receipt of customer payments, the timing of our payments to vendors and employees, and the timing of inventory turnover, adjusted for certain non-cash items that do not impact cash flows from operating activities.

Cash used in investing activities was approximately $5.8 million and $4.7 million for the six months ended June 30, 2022 and 2021, respectively, primarily due to software development costs of $5.1 million and $3.7 million for the six months ended June 30, 2022 and 2021, respectively, and the purchase of property and equipment.

Cash used in financing activities was $6.2 million for the six months ended June 30, 2022, compared to cash provided by financing activities of $33.0 million for the same period in 2021. This is primarily attributable to payments under finance leases for both periods, payment of tax withholding related to a net share settlement of an equity awards of $2.9 million in the first quarter of 2022 and the repurchase of common stock of $2.6 million under the share repurchase program described below in the second quarter of 2022. By contrast, in 2021 there was a cash inflow from the follow-on offering that generated $64.3 million of net proceeds, reduced by $2.4 million of final distributions to the Class B Members of Telos ID in the first quarter, $26.9 million used to repurchase the outstanding warrants and $1.3 million to repurchase the common stock held by EnCap fund holders.

Critical Accounting Policies and Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the U.S. requires us to make estimates, judgments, and assumptions that affect the amounts reported. Actual results could differ from those estimates. The 2021 Form 10-K, as filed with the SEC on March 28, 2022, includes a summary of critical accounting policies we believe are the most important to aid in understanding our financial results. There have been no changes to those critical accounting policies that have had a material impact on our reported amounts of assets, liabilities, revenues, or expenses during the six months ended June 30, 2022.

Item 3. Quantitative and Qualitative Disclosures about Market Risk

None.

Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

The Company has established disclosure controls and procedures to ensure that information required to be disclosed in this quarterly report on Form 10-Q was properly recorded, processed, summarized and reported within the time periods specified in the Commission's rules and forms. The Company's controls and procedures are designed to ensure that information required to be disclosed by the Company in the reports that it files or submits under the Securities Exchange Act of 1934, as amended (the "Exchange Act") is accumulated and communicated to the Company's management, including its principal executive and principal financial officer to allow timely decisions regarding required disclosure.

We carried out an evaluation of the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) at June 30, 2022, based on the evaluation of these controls and procedures required by paragraph (b) of Rule 13a-15 or Rule 15d-15 under the Exchange Act. This evaluation was carried out under the supervision and with the participation of our Chief Executive Officer and Chief Financial Officer. Based upon the evaluation, our Chief Executive Officer and Chief Financial Officer concluded that, on June 30, 2022, our disclosure controls and procedures were not effective as a result of the previously identified material weaknesses disclosed below.

Internal Control over Financial Reporting

In connection with its evaluation of the internal control over financial reporting for the year ended December 31, 2021, management identified the following material weaknesses in our internal control over financial reporting:

a. Management did not maintain appropriately designed entity-level controls impacting the control environment and monitoring activities to prevent or detect material misstatements to the consolidated financial statements. Specifically, the Company did not have sufficient qualified resources to effectively design, operate and oversee internal control over financial reporting, which contributed to the failure in the effectiveness of certain controls.

b. Management did not maintain appropriately designed information technology general controls in the areas of user access, change management, and segregation of duties, including controls over the recording of journal entries and safeguarding of assets, related to certain information technology systems that support the Company's financial reporting process.

c. Management did not maintain appropriately designed and implemented controls over the following:

    i. Recording of revenue in accordance with ASC Topic 606, "Revenue from Contracts with Customers."

    ii. Accounting for software development costs in accordance with ASC Topic 985-20, "Software – Costs of Software to be Sold, Leased, or Marketed," and ASC Topic 350-40, "Internal Use Software."

    iii. Review of completeness and accuracy of award stock-based compensation expense, and review of the key inputs and assumptions utilized in third-party valuations.

    iv. Preparation and review of projected financial information utilized in the valuation of the business combination.

    v. Financial statement close process to ensure the consistent execution, accuracy, and timely review of account reconciliations, as well as review of the statement of cash flows.

    vi. Coding of transactions within the purchase to disbursement cycle.

These material weaknesses were partially related to employee turnover, resulting in a temporary shortage of qualified personnel to effectively perform the internal controls referenced above.

The Company is working to remediate the material weaknesses in internal control over financial reporting and is taking steps to improve the internal control environment. Specifically, the Company is:

a. Hiring additional accounting personnel and implementing training of new and existing personnel on proper execution of designed control procedures;

b. Enhancing processes, and designing and implementing internal controls around revenue recognition, software development costs, stock-based compensation, business combination, and financial close and reporting; and,

c. Enhancing user access provisioning and monitoring controls to enforce appropriate system access and segregation of duties.

The material weaknesses will be considered remediated when management concludes that, through testing, the applicable remedial controls are designed and implemented effectively.

We are still assessing the design and operating effectiveness of these measures and, as such, the identified material weaknesses have not been fully remediated as of June 30, 2022. We will continue to monitor the effectiveness of these remediation measures and will make any changes and take other actions that we deem appropriate.

Changes in Internal Control over Financial Reporting

Other than the ongoing remediation activities listed above, there has been no change in our internal control over financial reporting during the quarter ended June 30, 2022 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

PART II—OTHER INFORMATION

Item 1. Legal Proceedings

Information regarding legal proceedings may be found in Note 19 – Commitments and Contingencies to the unaudited consolidated financial statements.

Item 1A. Risk Factors

There were no material changes in the period ended June 30, 2022, in our risk factors as disclosed in our Annual Report on Form 10-K for the year ended December 31, 2021.

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

(a) Unregistered Sales of Securities

None.

(b) Use of Proceeds

None.

(c) Issuer Purchases of Equity Securities

Common Stock Purchase Activity During the Three Months Ended June 30, 2022

Period	Total Number of Shares Purchased [(1)]	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Repurchases Plans [(1)]	Maximum Dollar Value of Shares that May Yet Be Purchased Under the Plans [(1)]
April 1, 2022 through April 30, 2022	—	$ —	—	$ —
May 1, 2022 through May 31, 2022	—	—	—	$ 50,000,000
June 1, 2022 through June 30, 2022	360,439	8.33	360,439	$ 46,997,511
Total	360,439	$ 8.33	360,439	

[(1)] On May 24, 2022, the Board of Directors authorized a share repurchase program, pursuant to which the Company can repurchase up to $50.0 million of issued and outstanding common stock. The repurchase program has no expiration date and may be modified, suspended, or terminated at any time. In June 2022, the Company repurchased 360,439 shares of common stock under the program for an aggregate price of $3.0 million in open market.

Item 3. Defaults upon Senior Securities

None.

Item 4. Mine Safety Disclosures

Not applicable.

Item 5. Other Information

None.

Item 6. Exhibits

Exhibit No.		Description of Exhibit
31.1	❖	Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.2	❖	Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32	z	Certification of Chief Executive Officer and Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
101.INS	❖	XBRL Instance Document - the instance document does not appear in the Interactive Data File because its XBRL tags are embedded within the Inline XBRL document
101.SCH	❖	XBRL Taxonomy Extension Schema
101.CAL	❖	XBRL Taxonomy Extension Calculation Linkbase
101.DEF	❖	XBRL Taxonomy Extension Definition Linkbase
101.LAB	❖	XBRL Taxonomy Extension Label Linkbase
101.PRE	❖	XBRL Taxonomy Extension Presentation Linkbase
104	❖	Cover Page Interactive Data File. (formatted as Inline XBRL tags and contained in Exhibit 101)

❖ Filed herewith.
z Furnished herewith.

SIGNATURES

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

TELOS CORPORATION

/s/ John B. Wood	August 9, 2022
By: John B. Wood Chief Executive Officer (Principal Executive Officer)	
/s/ Mark Bendza	August 9, 2022
By: Mark Bendza Chief Financial Officer (Principal Financial Officer)	
/s/ Victoria Harding	August 9, 2022
By: Victoria Harding Controller and Chief Accounting Officer (Principal Accounting Officer)	

Exhibit 31.1

CERTIFICATION

I, John B. Wood, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Telos Corporation;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:

a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):

a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: August 9, 2022

/s/ John B. Wood

John B. Wood
Chief Executive Officer (Principal Executive Officer)

Exhibit 31.2

CERTIFICATION

I, Mark Bendza, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Telos Corporation;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:

a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):

a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: August 9, 2022

/s/ Mark Bendza

Mark Bendza
Chief Financial Officer (Principal Financial Officer)

Exhibit 32

CERTIFICATION PURSUANT TO
18 U.S.C. SECTION 1350,
AS ADOPTED PURSUANT TO
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

In connection with the Quarterly Report of Telos Corporation (the "Company") on Form 10-Q for the period ended June 30, 2022, as filed with the Securities and Exchange Commission on the date hereof (the "Report"), we, John B. Wood and Mark Bendza, certify, pursuant to 18 U.S.C. § 1350, as adopted pursuant to § 906 of the Sarbanes-Oxley Act of 2002, that to our knowledge:

(1) The Report fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended; and

(2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Date: August 9, 2022

/s/ John B. Wood
John B. Wood
Chief Executive Officer (Principal Executive Officer)

Date: August 9, 2022

/s/ Mark Bendza
Mark Bendza
Chief Financial Officer (Principal Financial Officer)