# 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: September 30, 2021**

☐ 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 November 8, 2021, the registrant had outstanding 66,755,230 shares of common stock.

**TELOS CORPORATION**

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**PART I - FINANCIAL INFORMATION**

## PART I – FINANCIAL INFORMATION

### Item 1. Financial Statements

**TELOS CORPORATION**
**CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS**
**(Unaudited)**
**(amounts in thousands, except per share data)**

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2021 | 2020 | 2021 | 2020 |
| Revenue | | | | |
| Services | $ 63,690 | $ 44,166 | $ 163,366 | $ 124,210 |
| Products | 6,376 | 3,274 | 15,017 | 10,819 |
| | 70,066 | 47,440 | 178,383 | 135,029 |
| Costs and expenses | | | | |
| Cost of sales - Services | 40,031 | 28,619 | 109,134 | 82,862 |
| Cost of sales - Products | 3,967 | 2,259 | 8,266 | 5,790 |
| | 43,998 | 30,878 | 117,400 | 88,652 |
| Selling, general and administrative expenses | | | | |
| Sales and marketing | 5,363 | 1,491 | 14,233 | 4,556 |
| Research and development | 5,396 | 3,598 | 14,783 | 11,070 |
| General and administrative | 20,562 | 6,960 | 69,271 | 20,769 |
| | 31,321 | 12,049 | 98,287 | 36,395 |
| Operating (loss) income | (5,253) | 4,513 | (37,304) | 9,982 |
| Other income (expense) | | | | |
| Other income (expense) | 20 | 2 | (1,001) | 14 |
| Interest expense | (195) | (2,013) | (583) | (6,026) |
| (Loss) income before income taxes | (5,428) | 2,502 | (38,888) | 3,970 |
| Benefit from (provision for) income taxes | 41 | (8) | (6) | 136 |
| Net (loss) income | (5,387) | 2,494 | (38,894) | 4,106 |
| Less: Net income attributable to non-controlling interest | — | (2,694) | — | (6,284) |
| Net loss attributable to Telos Corporation | $ (5,387) | $ (200) | $ (38,894) | $ (2,178) |
| Net loss per share attributable to Telos Corporation, basic | $ (0.08) | $ (0.01) | $ (0.59) | $ (0.06) |
| Net loss per share attributable to Telos Corporation, diluted | $ (0.08) | $ (0.01) | $ (0.59) | $ (0.06) |
| Weighted-average shares of common stock outstanding, basic | 66,755 | 39,002 | 65,999 | 38,554 |
| Weighted-average shares of common stock outstanding, diluted | 66,755 | 39,002 | 65,999 | 38,554 |

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

**TELOS CORPORATION**
**CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE LOSS**
**(Unaudited)**
**(amounts in thousands)**

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | **2021** | **2020** | **2021** | **2020** |
| Net (loss) income | $ (5,387) | $ 2,494 | $ (38,894) | $ 4,106 |
| Other comprehensive loss, net of tax: | | | | |
| Foreign currency translation adjustments | (13) | (2) | (40) | (1) |
| Less: Comprehensive income attributable to non-controlling interest | — | (2,694) | — | (6,284) |
| Comprehensive loss attributable to Telos Corporation | $ (5,400) | $ (202) | $ (38,934) | $ (2,179) |

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

**TELOS CORPORATION**
**CONDENSED CONSOLIDATED BALANCE SHEETS**
**(amounts in thousands, except shares and par value data)**

| | September 30, 2021 | December 31, 2020 |
|---|---|---|
| | (Unaudited) | |
| **ASSETS** | | |
| Current assets | | |
| Cash and cash equivalents | $ 134,135 | $ 106,045 |
| Accounts receivable, net of reserve of $116 and $308, respectively | 49,759 | 30,913 |
| Inventories, net of obsolescence reserve of $849 and $851, respectively | 2,025 | 3,311 |
| Prepaid expenses | 5,440 | 3,059 |
| Other current assets | 941 | 786 |
| Total current assets | 192,300 | 144,114 |
| Property and equipment, net of accumulated depreciation and amortization of $33,805 and $32,057, respectively | 14,363 | 14,977 |
| Operating lease right-of-use assets | 1,004 | 1,464 |
| Goodwill | 16,642 | 14,916 |
| Intangible assets, net | 17,102 | 7,420 |
| Other assets | 1,256 | 926 |
| Total assets | $ 242,667 | $ 183,817 |
| **LIABILITIES AND STOCKHOLDERS' EQUITY** | | |
| Current liabilities | | |
| Accounts payable and other accrued liabilities | $ 35,102 | $ 20,899 |
| Accrued compensation and benefits | 7,955 | 8,474 |
| Contract liabilities | 7,232 | 5,654 |
| Finance lease obligations – short-term | 1,430 | 1,339 |
| Operating lease obligations – short-term | 602 | 677 |
| Other current liabilities | 2,089 | 1,903 |
| Total current liabilities | 54,410 | 38,946 |
| | | |
| Finance lease obligations – long-term | 13,218 | 14,301 |
| Operating lease obligations – long-term | 516 | 941 |
| Deferred income taxes | 680 | 652 |
| Other liabilities | 2,352 | 1,873 |
| Total liabilities | 71,176 | 56,713 |
| | | |
| Commitments and contingencies (Note 11) | | |
| | | |
| Stockholders' equity | | |
| Common stock, $0.001 par value, 250,000,000 shares authorized, 66,755,230 shares and 64,625,071 shares issued and outstanding as of September 30, 2021 and December 31, 2020, respectively | 105 | 103 |
| Additional paid-in capital | 354,119 | 270,800 |
| Accumulated other comprehensive income | 4 | 44 |
| Accumulated deficit | (182,737) | (143,843) |
| Total stockholders' equity | 171,491 | 127,104 |
| Total liabilities and stockholders' equity | $ 242,667 | $ 183,817 |

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

**TELOS CORPORATION**
**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**
**(Unaudited)**
**(amounts in thousands)**

| | Nine Months Ended September 30, | |
|---|---|---|
| | **2021** | **2020** |
| Operating activities: | | |
| Net (loss) income | $ (38,894) | $ 4,106 |
| Adjustments to reconcile net (loss) income to cash provided by operating activities: | | |
| Stock-based compensation | 47,197 | 4 |
| Dividends from preferred stock recorded as interest expense | — | 2,867 |
| Depreciation and amortization | 4,223 | 4,018 |
| Amortization of debt issuance costs | — | 684 |
| Deferred income tax provision | 28 | 28 |
| Other noncash items | 14 | (25) |
| Changes in other operating assets and liabilities | (5,900) | 275 |
| Cash provided by operating activities | 6,668 | 11,957 |
| Investing activities: | | |
| Cash paid for acquisition | (5,925) | — |
| Capitalized software development costs | (6,139) | (5,459) |
| Purchases of property and equipment | (1,645) | (624) |
| Cash used in investing activities | (13,709) | (6,083) |
| Financing activities: | | |
| Proceeds from issuance of common stock, net of issuance costs | 64,269 | — |
| Repurchase of outstanding warrants | (26,894) | — |
| Repurchase of common stock | (1,251) | — |
| Payments under finance lease obligations | (993) | (907) |
| Amendment fee paid to lender | — | (100) |
| Distributions to Telos ID Class B member - non-controlling interest | — | (1,292) |
| Cash provided by (used in) financing activities | 35,131 | (2,299) |
| Increase in cash and cash equivalents | 28,090 | 3,575 |
| Cash and cash equivalents, beginning of period | 106,045 | 6,751 |
| Cash and cash equivalents, end of period | $ 134,135 | $ 10,326 |
| Supplemental disclosures of cash flow information: | | |
| Cash paid during the period for: | | |
| Interest | $ 583 | $ 2,211 |
| Income taxes | $ 54 | $ 50 |
| Noncash: | | |
| Dividends from preferred stock recorded as interest expense | $ — | $ 2,867 |
| Supplemental disclosure of non-cash investing activity | | |
| Acquisition holdback | $ 506 | $ — |

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

**TELOS CORPORATION**
**CONDENSED CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY (DEFICIT)**
**(Unaudited)**
**(amounts in thousands)**

| | Common Stock | Additional Paid-in Capital | Accumulated Other Comprehensive Income | Accumulated Deficit | Non-Controlling Interest | Total Stockholders' Equity (Deficit) |
|---|---|---|---|---|---|---|
| **For the Three Months Ended September 30, 2021** | | | | | | |
| Beginning balance | $ 105 | $ 341,928 | $ 17 | $ (177,350) | $ — | $ 164,700 |
| Net loss | — | — | — | (5,387) | — | (5,387) |
| Foreign currency translation loss | — | — | (13) | — | — | (13) |
| Stock-based compensation | — | 12,191 | — | — | — | 12,191 |
| Ending balance | $ 105 | $ 354,119 | $ 4 | $ (182,737) | $ — | $ 171,491 |
| **For the Three Months Ended September 30, 2020** | | | | | | |
| Beginning balance | $ 78 | $ 4,310 | $ 7 | $ (147,508) | $ 7,104 | $ (136,009) |
| Net (loss) income | — | — | — | (200) | 2,694 | 2,494 |
| Foreign currency translation loss | — | — | (2) | — | — | (2) |
| Stock-based compensation | — | 4 | — | — | — | 4 |
| Distributions | — | — | — | — | (292) | (292) |
| Ending balance | $ 78 | $ 4,314 | $ 5 | $ (147,708) | $ 9,506 | $ (133,805) |
| **For the Nine Months Ended September 30, 2021** | | | | | | |
| Beginning balance | $ 103 | $ 270,800 | $ 44 | $ (143,843) | $ — | $ 127,104 |
| Net loss | — | — | — | (38,894) | — | (38,894) |
| Issuance of common stock | 2 | 64,267 | — | — | — | 64,269 |
| Foreign currency translation loss | — | — | (40) | — | — | (40) |
| Stock-based compensation | — | 47,197 | | — | — | 47,197 |
| Repurchase of outstanding warrants | — | (26,894) | — | — | — | (26,894) |
| Repurchase of common stock | — | (1,251) | — | — | — | (1,251) |
| Ending balance | $ 105 | $ 354,119 | $ 4 | $ (182,737) | $ — | $ 171,491 |
| **For the Nine Months Ended September 30, 2020** | | | | | | |
| Beginning balance | $ 78 | $ 4,310 | $ 6 | $ (145,530) | $ 4,514 | $ (136,622) |
| Net (loss) income | — | — | — | (2,178) | 6,284 | 4,106 |
| Foreign currency translation loss | — | — | (1) | — | — | (1) |
| Stock-based compensation | — | 4 | — | — | — | 4 |
| Distributions | — | — | — | — | (1,292) | (1,292) |
| Ending balance | $ 78 | $ 4,314 | $ 5 | $ (147,708) | $ 9,506 | $ (133,805) |

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

**TELOS CORPORATION**
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**
**(Unaudited)**

## Note 1. General and Basis of Presentation

***Description of Business***

*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 own 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 condensed consolidated financial statements and notes to the condensed consolidated financial statements give retroactive effect to the reverse stock split for all periods presented.

*Public Offerings of Common Stock*

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.

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 have used and intend to continue using the remaining net proceeds for general corporate purposes, including working capital, sales and marketing activities, research and development, general and administrative matters and capital expenditures. We also may use a portion of the net proceeds to acquire complementary businesses, products, services, or technologies. The amounts and timing of our actual use of the net proceeds will vary depending on numerous factors.

***Principles of Consolidation and Reporting***

The accompanying unaudited condensed consolidated financial statements include the accounts of Telos and its wholly-owned subsidiaries. All intercompany transactions have been eliminated in consolidation.

The accompanying condensed consolidated financial statements for the three and nine months ended September 30, 2021 and 2020 have been prepared in accordance with accounting principles generally accepted in the United States of America (“GAAP”) and pursuant to rules and regulations of the Securities and Exchange Commission (“SEC”). The presented interim results are not necessarily indicative of fiscal year performance for a variety of reasons including, but not limited to, the impact of seasonal and short-term variations. We have continued to follow the accounting policies (including the critical accounting policies) set forth in the consolidated financial statements included in our 2020 Annual Report on Form 10-K filed with the SEC. These condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and notes thereto included in our Annual Report on Form 10-K for the fiscal year ended December 31, 2020.

In preparing these condensed consolidated financial statements, we have evaluated subsequent events through the date that these condensed consolidated financial statements were issued.

### *Basis of Comparison*

Certain prior-period amounts have been reclassified to conform to the current period presentation. In the current period, we have reclassified and presented intangible assets separately from our property and equipment line item. The reclassification had no impact on our total assets or liabilities nor on our net loss or stockholders' equity.

For the three months ended September 30, 2021, the Company recorded an out-of-period adjustment resulting in a $1.1 million increase to 'Services' revenue and a $1.0 million reclassification between 'Cost of Sales - Services' and 'General and Administrative' expenses within the condensed consolidated statements of operations. The Company identified and corrected this error in the current period. This error was not material to any previously filed consolidated financial statements and the impact of correcting this error in the current period is not material to our third quarter 2021 condensed consolidated financial statements.

### *Segment Reporting*

Operating segments are defined as components of an enterprise for which separate 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. We currently operate in one operating and reportable business segment for financial reporting purposes. Our Chief Executive Officer is the CODM. The CODM evaluates profitability based on consolidated results.

### *Recent Accounting Pronouncements*

*Accounting Standards Recently Adopted*

In December 2019, the Financial Accounting Standard Board (“FASB”) issued Accounting Standards Update (“ASU”) No. 2019-12, “Simplifying the Accounting for Income Taxes (Topic 740)”, which simplifies the accounting for income taxes by removing certain exceptions to the general principles in Topic 740. The ASU also clarifies and amends existing guidance to improve consistent application. This standard is effective for reporting periods beginning after December 15, 2020, which made this standard effective for us on January 1, 2021. The adoption of this ASU did not have a material impact on our condensed consolidated financial position, results of operations and cash flows.

### *Summary of Significant Accounting Policies*

*Inventories*

Inventories are stated at the lower of cost or net realizable value, where cost is determined using the weighted average method. Substantially all inventories consist of purchased off-the-shelf hardware and software, and component computer parts used in connection with system integration services that we perform. An allowance for obsolete, slow-moving or nonsaleable inventory is provided for all other inventories. This allowance is based on our overall obsolescence experience and our assessment of future inventory requirements. This charge is taken primarily due to the age of the specific inventory and the significant additional costs that would be necessary to upgrade to current standards as well as the lack of forecasted sales for such inventory in the near future. Gross inventory was $2.9 million and $4.2 million as of September 30, 2021 and December 31, 2020, respectively. As of September 30, 2021, it is management’s judgment that we have fully provided for any potential inventory obsolescence, which was $0.8 million and $0.9 million as of September 30, 2021 and December 31, 2020, respectively.

*Software Development Costs*

We account for development costs of our software to be sold in accordance with ASC Topic 985-20, “Software – Costs of Software to be Sold, Leased, or Marketed” and for internal use software in accordance with ASC Topic 350-40 “Internal Use Software”. Under both standards, software development costs are expensed as incurred until technological feasibility is reached, at which time additional costs are capitalized until the product is available for general release to customers or is ready for its intended use, as appropriate. Technological feasibility is established when all planning, designing, coding and testing activities have been completed, and all risks have been identified. Software development costs are capitalized and amortized over the estimated product life of 2 years on a straight-line basis, which are included as a part of intangible assets. The Company analyzes the net realizable value of capitalized software development costs on at least an annual basis and has determined that there is no indication of impairment of the capitalized software development costs as forecasted future sales are adequate to support the carrying values.

*Income Taxes*

We account for income taxes in accordance with ASC 740, “Income Taxes”. Under ASC 740, deferred tax assets and liabilities are recognized for the estimated future tax consequences of temporary differences and income tax credits. Deferred tax assets and liabilities are measured by applying enacted statutory tax rates that are applicable to the future years in which deferred tax assets or liabilities are expected to be settled or realized for differences between the financial statement carrying amounts and the tax bases of existing assets and liabilities. Any change in tax rates on deferred tax assets and liabilities is recognized in net income in the period in which the tax rate change is enacted.

We follow the provisions of ASC 740 related to accounting for uncertainty in income taxes. The accounting estimates related to liabilities for uncertain tax positions require us to make judgments regarding the sustainability of each uncertain tax position based on its technical merits. If we determine it is more likely than not that a tax position will be sustained based on its technical merits, we record the impact of the position in our condensed consolidated financial statements at the largest amount that is greater than fifty percent likely of being realized upon ultimate settlement. These estimates are updated at each reporting date based on the facts, circumstances and information available. We are also required to assess at each reporting date whether it is reasonably possible that any significant increases or decreases to our unrecognized tax benefits will occur during the next 12 months.

The provision for income taxes in interim periods is computed by applying the estimated annual effective tax rate against earnings before income tax expense for the period. In addition, non-recurring or discrete items are recorded during the period in which they occur.

*Goodwill*

Goodwill is recorded as the difference between the aggregate consideration paid for an acquisition and the fair value of net tangible and intangible assets acquired and liabilities assumed. Goodwill is not amortized, but rather tested for potential impairment annually during our fourth quarter, or whenever events or changes in circumstances indicate that the carrying value may not be recoverable. Such circumstances could include, but are not limited to: (1) a significant adverse change in legal factors or business climate, or (2) a loss of key contracts or customers.

The goodwill impairment test is performed at the reporting unit level. The Company estimates and compares the fair value of each reporting unit to its respective carrying value including goodwill. If the fair value is less than the carrying value, the amount of impairment expense is equal to the difference between the reporting unit’s fair value and the reporting unit’s carrying value.

Goodwill is amortized and deducted over a 15-year period for tax purposes.

*Stock-Based Compensation*

Under our 2016 Omnibus Long-Term Incentive Plan, as amended (the “2016 LTIP”), we have the ability to award restricted stock units with time-based vesting (“Service-Based RSUs”), and restricted stock units with performance-based vesting (“Performance-Based RSUs”) to senior executives, directors, employees and other eligible service providers. Under the 2016 LTIP, our Board of Directors or, by designation of authority, the Compensation Committee of our Board of Directors has the discretion to establish the terms, conditions and criteria of the various awards, including the weighing and vesting schedule of Service-Based RSUs and the performance conditions applicable to the Performance-Based RSUs, including the achievement of certain financial performance criteria or price targets for our common stock. Upon vesting, Service-Based RSUs and Performance-Based RSUs will be settled in the Company’s common stock.

- *Service-Based RSUs* granted to eligible employees as an incentive generally vest in equal installments over two to three years from the date of grant. Service-Based RSUs granted to senior executives in 2021 vest in three annual installments from the date of grant, with 30% vesting on the first and second anniversaries and 40% vesting on the third anniversary. The grant date fair value per share is equal to the closing stock price on the date of grant.

- *Performance-Based RSUs* may vest upon the achievement of a defined performance target or at the end of the defined performance period from the date of grant, whichever initially occurs. The grant date fair value per share of these Performance-Based RSUs is equal to the closing stock price on the date of the grant or the fair value of the award on the grant date as determined through an independent valuation, for performance-based RSUs with market condition. Performance-Based RSUs may vest upon the achievement of certain price targets for the Company's common stock anytime over a three-year period from the date of grant. In order to reflect the substantive characteristics of these market condition awards, the Company employs a Monte Carlo simulation valuation model to calculate the grant date fair value and corresponding requisite service period of the award. Monte Carlo approaches are a class of computational algorithms that rely on repeated random sampling to compute their results. This approach allows the calculation of the value of such awards based on a large number of possible stock price path scenarios.

We recognize these share-based payment transactions when services from the employees are received and recognize a corresponding increase in additional paid-in capital in our condensed consolidated balance sheets. The measurement objective for these equity awards is the estimated fair value at the date of grant of the equity instruments that we are obligated to issue when employees have rendered the requisite service and satisfied any other conditions necessary to earn the right to benefit from the instruments. The compensation expense for an award is recognized ratably over the requisite service period for the entire award, which is the period during which an employee is required to provide service in exchange for an award. Compensation expense for awards with performance conditions is recognized over the requisite service period if it is probable that the performance condition will be satisfied. If such performance conditions are not or are no longer considered probable, no compensation expense for these awards is recognized, and any previously recognized expense is reversed. If the performance condition is achieved prior to the completion of the requisite service period, any unrecognized compensation expense will be recognized in the period the performance condition is achieved. Compensation expense for awards with market conditions is recognized over the derived service period, or sooner, if the market condition is achieved. Previously recognized expense for awards with market conditions will never be reversed even if the market conditions is never achieved. We recognize forfeitures of share-based compensation awards as they occur. Share-based compensation expense is recognized as part of cost of sales and general and administrative expenses in our condensed consolidated statements of operations.

*Net 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 stock, unvested restricted stock units and common stock 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. Potentially dilutive securities are as follows (in common stock equivalent shares, in thousands):

| | **Three Months Ended September 30,** | | **Nine Months Ended September 30,** | |
|---|---|---|---|---|
| | **2021** | **2020** | **2021** | **2020** |
| Unvested restricted stock and restricted stock units | 313 | 60 | 394 | 60 |
| Common stock warrants, exercisable at $1.665/sh. | — | 901 | 405 | 901 |
| Total | 313 | 961 | 799 | 961 |

*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 (deficit) as a component of accumulated other comprehensive income (loss).

Accumulated other comprehensive income included within stockholders' equity (deficit) consists of the following (in thousands):

| | September 30, 2021 | December 31, 2020 |
|---|---|---|
| Cumulative foreign currency translation loss | $ (103) | $ (63) |
| Cumulative actuarial gain on pension liability adjustment | 107 | 107 |
| Accumulated other comprehensive income | $ 4 | $ 44 |

**Note 2. Revenue Recognition**

*Performance Obligation*

We account for 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. Timing of the satisfaction of performance obligations varies across our businesses due to our diverse product and service mix, customer base, and contractual terms. Significant judgment can be required in determining certain performance obligations, and these determinations could change the amount of revenue and profit recorded in a given period. Our contracts may have a single performance obligation or multiple performance obligations. When there are multiple performance obligations within a contract, we allocate the transaction price to each performance obligation based on our best estimate of standalone selling price.

Contracts are routinely and often modified to account for changes in contract requirements, specifications, quantities, or price. Depending on the nature of the modification, we determine whether to account for the modification as an adjustment to the existing contract or as a new contract. Generally, modifications are not distinct from the existing contract due to the significant interrelatedness of the performance obligations and are therefore accounted for as an adjustment to the existing contract, and recognized as a cumulative adjustment to revenue (as either an increase or reduction of revenue) based on the modification's effect on progress toward completion of a performance obligation.

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 91% and 92% of our revenue for the three and nine months ended September 30, 2021, and 93% and 92% of our revenue for the three and nine months ended September 30, 2020. 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 is recognized over time using costs incurred to date relative to total estimated costs at completion to measure progress toward satisfying our performance obligations. Incurred cost represents work performed, which corresponds with, and thereby best depicts, the transfer of control to the customer. Contract costs include labor, material, subcontractor costs and indirect expenses.

Revenue that is recognized at a point in time is for the sale of software licenses in our Information Assurance / Xacta® and Secure Communications business groups and for the sale of resold products in Telos ID and Secure Networks, and is classified as product revenue. Revenue transferred to customers at a point in time accounted for 9% and 8% of our revenue for the three and nine months ended September 30, 2021 and 7% and 8% of our revenue for the three and nine months ended September 30, 2020. 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. Orders for the sale of software licenses may contain multiple performance obligations, such as maintenance, training, or consulting services, which are typically delivered over time, consistent with the transfer of control disclosed above for the provision of services. When an order contains multiple performance obligations, we allocate the transaction price to the performance obligations using our best estimate of standalone selling price.

*Contract Estimates*

Due to the transfer of control over time, revenue is recognized based on progress towards completion of the performance obligation. The selection of the method to measure progress towards completion requires judgment and is based on the nature of the performance obligations. We generally use the cost-to-cost measure of progress on a proportional performance basis for our contracts because it best depicts the transfer of control to the customer which occurs as we incur costs on our contracts. Under the cost-to-cost measure of progress, the extent of progress towards completion is measured based on the ratio of costs incurred to date to the total estimated costs at completion of the performance obligation. Revenues are recorded proportionally as costs are incurred. Due to the nature of the work required to be performed on certain of our performance obligations, the estimation of total revenue and cost at completion is complex, subject to many variables and requires significant judgment. Contract estimates are based on various assumptions including labor and subcontractor costs, materials and other direct costs and the complexity of the work to be performed. A significant change in one or more of these estimates could affect the profitability of our contracts. We review and update our contract-related estimates regularly and recognize adjustments in estimated profit on contracts on a cumulative catch-up basis, which may result in an adjustment increasing or decreasing revenue to date on a contract in a particular period that the adjustment is identified. Revenue and profit in future periods of contract performance are recognized using the adjusted estimate.

Our contracts may include various types of variable consideration, such as claims (for instance, indirect rate or other equitable adjustments) or incentive fees. We include estimated amounts in the transaction price based on all of the information available to us, including historical information and future estimations, and to the extent it is probable that a significant reversal of cumulative revenue recognized will not occur when any uncertainty associated with the variable consideration is resolved.

Historically, most of our contracts do not include award or incentive fees. For incentive fees, we would include such fees in the transaction price to the extent we could reasonably estimate the amount of the fee. With limited historical experience, we have not included any revenue related to incentive fees in our estimated transaction prices. We may include in our contract estimates additional revenue for submitted contract modifications or claims against the customer when we believe we have an enforceable right to the modification or claim, the amount can be estimated reliably and its realization is probable. We consider the contractual/legal basis for the claim (in particular the FAR provisions), the facts and circumstances around any additional costs incurred, the reasonableness of those costs and the objective evidence available to support such claims.

For our contracts that have an original duration of one year or less, we use the practical expedient applicable to such contracts and do not consider the time value of money. We capitalize sales commissions related to proprietary software and related services that are directly tied to sales. We do not elect the practical expedient to expense as incurred the incremental costs of obtaining a contract if the amortization period would have been one year or less. For the sales commissions that are capitalized, we amortize the asset over the expected customer life, which is based on recent and historical data.

We have one reportable segment in accordance with ASC 280, *Segment Reporting,* as such, the disaggregation of revenue below reconciles directly to its unique reportable segment. 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 from U.S. customers as revenue derived from international customers is not currently meaningful.

The following tables disclose revenue (in thousands) by customer type and contract type for the three and nine months ended September 30, 2021 and 2020.

| | **Three Months Ended September 30,** | | **Nine Months Ended September 30,** | |
|---|---|---|---|---|
| | **2021** | **2020** | **2021** | **2020** |
| Federal | $ 67,697 | $ 45,788 | $ 171,091 | $ 128,756 |
| State & Local, and Commercial | 2,369 | 1,652 | 7,292 | 6,273 |
| Total | $ 70,066 | $ 47,440 | $ 178,383 | $ 135,029 |

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2021 | 2020 | 2021 | 2020 |
| Firm-fixed-price | $ 61,434 | $ 39,483 | $ 155,832 | $ 113,080 |
| Time-and-materials | 3,154 | 3,605 | 9,243 | 11,066 |
| Cost plus fixed fee | 5,478 | 4,352 | 13,308 | 10,883 |
| Total | $ 70,066 | $ 47,440 | $ 178,383 | $ 135,029 |

*Contract Balances*

Contract assets are amounts that are invoiced as work progresses in accordance with agreed-upon contractual terms, either at periodic intervals or upon achievement of contractual milestones. Generally, revenue recognition occurs before billing, resulting in contract assets. These contract assets are referred to as unbilled receivables and are reported within accounts receivable, net of reserve on our condensed consolidated balance sheets.

Billed receivables are amounts billed and due from our customers and are reported within accounts receivable, net of reserve on the condensed consolidated balance sheets. The portion of the payments retained by the customer until final contract settlement is not considered a significant financing component due to the intent of the retainage being the customer's protection with respect to full and final performance under the contract.

Contract liabilities are payments received in advance and milestone payments from our customers on selected contracts that exceed revenue earned to date, resulting in contract liabilities. Contract liabilities typically are not considered a significant financing component because they are generally satisfied within one year and are used to meet working capital demands that can be higher in the early stages of a contract. Contract liabilities are reported on our condensed consolidated balance sheets on a net contract basis at the end of each reporting period. As of September 30, 2021 and December 31, 2020, the contract liabilities primarily related to product support services.

The following table provides information about accounts receivable, contract assets and contract liabilities (in thousands):

| | September 30, 2021 | December 31, 2020 |
|---|---|---|
| Billed accounts receivable | $ 10,158 | $ 12,060 |
| Unbilled receivables | 39,717 | 19,161 |
| Allowance for doubtful accounts | (116) | (308) |
| Accounts receivable – net | $ 49,759 | $ 30,913 |
| Contract liabilities | $ 7,232 | $ 5,654 |

Significant changes in the contract liabilities balance (in thousands):

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2021 | 2020 | 2021 | 2020 |
| Revenue recognized that was included in the opening contract liability balance | $ 823 | $ 1,690 | $ 4,065 | $ 5,208 |

| | September 30, 2021 | December 31, 2020 |
|---|---|---|
| | (in thousands) | (in thousands) |
| Remaining performance obligations (funded backlog) | $ 163,351 | $ 127,735 |

We expect to recognize approximately 95% of our remaining performance obligations over the next 12 months and the balance thereafter.

**Note 3. Non-controlling Interests / Purchase of Telos ID**

On April 11, 2007, Telos ID was formed as a limited liability company under the Delaware Limited Liability Company Act. We contributed substantially all of the assets of our Telos ID Enterprise business line and assigned our rights to perform under our U.S. Government contract with the Defense Manpower Data Center to Telos ID at their stated book value, amounting to $17,000. Until April 19, 2007, we owned 99.999% of the membership interests of Telos ID and Hoya ID Funds A, LLC ("Hoya") owned 0.001% of the membership interests of Telos ID. On April 20, 2007, we sold an additional 39.999% of the membership interests to Hoya for $6 million in cash consideration, resulting in 60% ownership of Telos ID.

On December 24, 2014, Hoya acquired from the Company an additional ten percent (10%) membership interest in Telos ID in exchange for $5 million (the “2014 Transaction”). In connection with the 2014 Transaction, the Company and Hoya entered into the Second Amended and Restated Operating Agreement (the “Operating Agreement”) governing the business, allocation of profits and losses and management of Telos ID. Under the Operating Agreement, Telos ID was managed by a board of directors comprised of five (5) members (the “Telos ID Board”). The Company owned 50% of Telos ID, was entitled to receive 50% of the profits of Telos ID, and could appoint three (3) members of the Telos ID Board. Hoya owned 50% of Telos ID, was entitled to receive 50% of the profits of Telos ID, and could appoint two (2) members of the Telos ID Board.

As a result of the 2014 Transaction, each of the members owned 50% of Telos ID, as mentioned above, and as such each was allocated 50% of the profits, which was $2.7 million and $6.3 million for the three and nine months ended September 30, 2020, respectively. Hoya held the non-controlling interest.

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 7,278,040 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.

Distributions were made to the members only when and to the extent determined by Telos ID’s Board of Directors, in accordance with the Operating Agreement. Hoya received a final distribution of $2.4 million in January 2021, which was accrued and presented in accounts payable and other accrued liabilities in the condensed consolidated balance sheets as of December 31, 2020. Hoya received a total distribution of $0.3 million and $1.3 million during the three and nine months ended September 30, 2020, respectively.

**Note 4. 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 DFT has been accounted for under US GAAP using the acquisition method of accounting. The total purchase consideration of $6.7 million has been allocated among the assets acquired at their acquisition date. We have calculated the fair values of the DFT acquired assets based on our preliminary valuation analysis, using the information available to us. The Company may continue to adjust the preliminary purchase price allocation (including the identified intangible assets) as additional information becomes available during the remainder of the measurement period, which will not exceed 12 months from the closing of the acquisition. Measurement period adjustments will be recognized in the reporting period in which the adjustment amounts are determined. Any such adjustments may be material.

The Company recognized $5.0 million of intangible assets and $1.7 million of goodwill, which is housed in the Telos ID reporting unit. Goodwill is primarily attributable to expected synergies between the acquired intangible assets and the Company's digital identify technology and solutions and acquired workforce. 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.

The results of DFT operations have been included in our condensed consolidated statements of operations from the acquisition date, and are not material for the three and nine months ended September 30, 2021. Acquisition-related costs were immaterial and have been expensed as incurred. The pro-forma financial information have not been presented for this acquisition as the impact to our condensed consolidated financial statements is not material.

**Note 5. Goodwill**

The goodwill balance was $16.6 million and $14.9 million as of September 30, 2021 and December 31, 2020, respectively. 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 nine months ended September 30, 2021 and 2020, no impairment charges were taken.

**Note 6. Intangible Assets**

Intangible assets, all of which are finite-lived, consists of the following (in thousands):

| September 30, 2021 | Estimated Useful Life | Gross Carrying Amount | Accumulated Amortization | Net Carrying Value |
|---|---|---|---|---|
| Acquired technology | 8 years | $ 4,910 | $ (112) | $ 4,798 |
| Customer relationships | 3 years | 40 | (2) | 38 |
| Software development costs | 2 years | 18,392 | (6,126) | 12,266 |
| | | $ 23,342 | $ (6,240) | $ 17,102 |

| December 31, 2020 | Estimated Useful Life | Gross Carrying Amount | Accumulated Amortization | Net Carrying Value |
|---|---|---|---|---|
| Acquired technology | | $ — | $ — | $ — |
| Customer relationships | | — | — | — |
| Software development costs | 2 years | 12,253 | (4,833) | 7,420 |
| | | $ 12,253 | $ (4,833) | $ 7,420 |

Amortization expense was $0.5 million and $1.4 million for the three and nine months ended September 30, 2021, respectively; and $0.4 million and $1.3 million for the three and nine months ended September 30, 2020, respectively.

**Note 7. Fair Value Measurements**

The accounting standard for fair value measurements provides a framework for measuring fair value and expands disclosures about fair value measurements. The framework requires the valuation of financial instruments using a three-tiered approach. The statement requires fair value measurement to be classified and disclosed in one of the following categories:

Level 1: Unadjusted quoted prices in active markets that are accessible at the measurement date for identical, unrestricted assets and liabilities;

Level 2: Quoted prices in markets that are not active, or inputs which are observable, either directly or indirectly, for substantially the full term of the asset or liability; or

Level 3: Prices or valuation techniques that require inputs that are both significant to the fair value measurement and unobservable (i.e. supported by little or no market activity).

As of September 30, 2021 and December 31, 2020, we did not have any financial instruments with significant Level 3 inputs and we did not have any financial instruments that are measured at fair value on a recurring basis.

For certain of our non-derivative financial instruments, including receivables, accounts payable and other accrued liabilities, the carrying amount approximates fair value due to the short-term maturities of these instruments.

**Note 8. Debt Obligations**

*Enlightenment Capital Credit Agreement*

On January 25, 2017, we entered into a Credit Agreement (the "Credit Agreement") with Enlightenment Capital Solutions Fund II, L.P., as agent (the "Agent") and the lenders party thereto (the "Lenders"), (together referenced as “EnCap”). The Credit Agreement provides for an $11 million senior term loan (the "Loan") with a maturity date of January 25, 2022, subject to acceleration in the event of customary events of default. All borrowings under the Credit Agreement accrued interest at the rate of 13.0% per annum.

In connection with the Credit Agreement, on January 25, 2017, the Company issued warrants (each, a "Warrant") to the Agent and certain of the Lenders representing in the aggregate the right to purchase in accordance with their terms 900,970 shares of the Class A Common Stock of the Company, no par value per share, which was equivalent to approximately 2.5% of the common equity interests of the Company on a fully diluted basis on the date of grant. The exercise price was $1.665 per share. The value of the warrants was determined to be de minimis and no value was allocated to them on a relative fair value basis in accounting for the debt instrument.

The Credit Agreement also included an $825,000 exit fee, which was payable upon any repayment or prepayment of the loan. This amount had been included in the total principal due and treated as an unamortized discount on the debt, which would be amortized over the term of the loan, using the effective interest method at a rate of 15.0% at the time of the original loan. We incurred fees and transaction costs of approximately $374,000 related to the issuance of the Credit Agreement, which were amortized over the life of the Credit Agreement.

On March 30, 2018, the Credit Agreement was amended (the “Third Amendment”) to add a minimum revenue covenant and a net working capital covenant were added. In consideration of these amendments, the interest rate on the loan was increased by 1% which will revert back to the original rate upon achievement of two consecutive quarters of a specified fixed charge coverage ratio as defined in the agreement. The increase in interest expense has been paid in cash. Contemporaneously with the Third Amendment, Mr. John B. Wood agreed to transfer 50,000 shares of the Company’s Class A Common Stock owned by him to EnCap.

On July 19, 2019, we entered into the Fourth Amendment to Credit Agreement and Waiver; First Amendment to Fee Letter (“Fourth Amendment”) to amend the Credit Agreement. As a result of the Fourth Amendment, several terms of the Credit Agreement were amended, including (but not limited to) the following:

- The Company borrowed an additional $5 million from the Lenders, increasing the total amount of the principal to $16 million.
- The maturity date of the Credit Agreement was amended from January 25, 2022 to January 15, 2021.
- The prepayment price was amended as follows: (a) from January 26, 2019 through January 25, 2020, the prepayment price is 102% of the principal amount, (b) from January 26, 2020 through October 14, 2020, the prepayment price is 101% of the principal amount, and (c) from October 15, 2020 to the maturity date, the prepayment price will be at par. However, the prepayment price for the additional $5 million loan attributable to the Fourth Amendment will be at par.
- The exit fee was increased from $825,000 to $1,200,000.

The exit fee had been included in the total principal due and treated as an unamortized discount on the debt, which was amortized over the term of the loan using the effective interest method at a rate of 17.3% over the remaining term of the loan.

On March 26, 2020, the Credit Agreement was amended (the “Fifth Amendment”) to modify the financial covenants and to update the previously agreed-upon definition of certain financial covenants, specifically the amount of Capital Expenditures to be included in the measurement of the covenants. The Fifth Amendment provides for four quarterly maturity date extensions, which would increase the Exit Fee payable under the Credit Agreement by $250,000 for each quarterly maturity date extension elected, for a total of $1 million increase to the Exit Fee were all four of the maturity date extensions to be elected. The Company paid EnCap an amendment fee of $100,000 and out-of-pocket costs and expenses in consideration for the Fifth Amendment.

We incurred interest expense in the amount of $0.8 million and $2.3 million for the three and nine months ended September 30, 2020, respectively, under the Credit Agreement.

On November 24, 2020, upon the closing of the IPO, the Company paid a total of $17.4 million to satisfy its obligations under the Credit Agreement in full including an exit fee of $1.2 million, accrued interest of $138,000, and legal fees of $13,000.

On April 19, 2021, the Company entered into multiple Redemption Agreements and Warrant Redemption and Cancellation Agreements (collectively the "Repurchase Agreement") with EnCap and certain related funds that held the warrants to purchase 900,970 shares of the Company's common stock in addition to 39,682 shares of the Company's common stock. Under the Repurchase Agreement, the Company agreed to repurchase the outstanding warrants for $26.9 million and common stock for $1.3 million. The average price of the warrants and common stock repurchased were $29.85 per share and $31.51 per share, respectively. Upon settlement, the repurchased warrants were retired. The Company reduced common stock for the $0.001 par value of the shares repurchased, with the excess purchase price over par value recorded as a reduction of additional paid-in-capital ("APIC"). As a result of the repurchases, the Company recognized these amounts as a reduction to APIC.

*Subordinated Debt*

On March 31, 2015, the Company entered into Subordinated Loan Agreements and Subordinated Promissory Notes (“Porter Notes”) with affiliated entities of Mr. John R. C. Porter (together referenced as “Porter”). At the time, Mr. Porter and Toxford Corporation, of which Mr. Porter controls as the co-trustee of the trust that is the sole stockholder of Toxford, owned 35.0% of our Class A Common Stock. Under the terms of the Porter Notes, Porter lent the Company $2.5 million on or about March 31, 2015. Telos also entered into Subordination and Intercreditor Agreements with Porter and a prior senior lender, in which the Porter Notes were fully subordinated to the financing provided by that senior lender, and payments under the Porter Notes were permitted only if certain conditions were met. According to the original terms of the Porter Notes, the outstanding principal sum bore interest at the fixed rate of twelve percent (12%) per annum which would be payable in arrears in cash on the 20th day of each May, August, November and February, with the first interest payment date due on August 20, 2015. The Porter Notes did not call for amortization payments and were unsecured. The Porter Notes, in whole or in part, may be repaid at any time without premium or penalty. The unpaid principal, together with interest, was originally due and payable in full on July 1, 2017.

On April 18, 2017, we amended and restated the Porter Notes to reduce the interest rate from twelve percent (12%) to six percent (6%) per annum, to be accrued, and extended the maturity date from July 1, 2017 to July 25, 2022. Telos also entered into Intercreditor Agreements with Porter and EnCap, in which the Porter Notes were fully subordinated to the Credit Agreement and any subsequent senior lenders, and payments under the Porter Notes were permitted only if certain conditions were met. All other terms remained in full force and effect.

We incurred interest expense in the amount of $90,000 and $265,000 for the three and nine months ended September 30, 2020, respectively, on the Porter Notes.

On November 23, 2020, upon the closing of the IPO, the Porter Notes were paid in full.

**Note 9**. **Exchangeable Redeemable Preferred Stock Conversion**

*Public Preferred Stock*

A maximum of 6,000,000 shares of Exchangeable Redeemable Preferred Stock (the "Public Preferred Stock"), par value $.01 per share, has been authorized for issuance. We initially issued 2,858,723 shares of the Public Preferred Stock pursuant to the acquisition of the Company during fiscal year 1990. The Public Preferred Stock was recorded at fair value on the date of original issue, November 21, 1989, and we made periodic accretions under the interest method of the excess of the redemption value over the recorded value. We adjusted our estimate of accrued accretion in the amount of $1.5 million in the second quarter of 2006. The Public Preferred Stock was fully accreted as of December 2008. We declared stock dividends totaling 736,863 shares in 1990 and 1991. Since 1991, no other dividends, in stock or cash, had been declared. In November 1998, we retired 410,000 shares of the Public Preferred Stock.

We paid dividends on the Public Preferred Stock when and if declared by the Board of Directors. The Public Preferred Stock accrued a semi-annual dividend at the annual rate of 12% ($1.20) per share, based on the liquidation preference of $10 per share, and was fully cumulative. Dividends in additional shares of the Public Preferred Stock for 1990 and 1991 were paid at the rate of 6% per share for each $.60 of such dividends not paid in cash. We accrued dividends on the Public Preferred Stock of $1.0 million and $2.9 million for the three and nine months ended September 30, 2020, respectively, which was recorded as interest expense. Prior to the effective date of ASC 480 on July 1, 2003, such dividends were charged to stockholders’ accumulated deficit.

Upon the closing of the IPO, which constituted a qualified initial public offering for the purposes of the terms of the Public Preferred Stock, each issued and outstanding share of Public Preferred Stock automatically was converted (the “ERPS Conversion”) into the right to receive (i) an amount of cash equal to (I) the ERPS Liquidation Value; multiplied by (II) 0.90; multiplied by (III) 0.85 and (ii) that number of shares of common stock (valued at the initial offering price to the public) equal to (I) the ERPS Liquidation Value; multiplied by (II) 0.90; multiplied by (III) 0.15. No fractional shares of common stock, however, were issued upon the ERPS Conversion but, in lieu thereof, the holder was entitled to receive an amount of cash equal to the fair market value of a share of common stock (valued at the initial offering price to the public) at the time of the ERPS Conversion multiplied by such fractional amount (rounded to the nearest cent). “ERPS Liquidation Value” means, per each share of Public Preferred Stock, $10 together with all accrued and unpaid dividends (whether or not earned or declared) thereon calculated as of the actual date of the ERPS Conversion without interest, which, was approximately $142.3 million as of November 19, 2020. All shares of common stock issued upon an ERPS Conversion were validly issued, fully paid and non-assessable.

On November 23, 2020, holders of the Public Preferred Stock received $108.9 million in cash and 1.1 million shares of our common stock at $17 per share for a total value of $19.2 million in connection with the ERPS Conversion. The difference in the redemption value of the ERPS and the carrying value has been accounted for as a gain on extinguishment of debt in accordance with ASC 470 and ASC 480. Approximately $0.2 million of costs directly attributable to this redemption were applied against the gain, resulting in a net gain of $14.0 million.

**Note 10**. **Income Taxes**

We establish a valuation allowance for deferred tax assets if, based on the weight of available evidence, it is more likely than not that some portion or all of the deferred tax assets will not be realized. Based on available evidence, realization of deferred tax assets is dependent upon the generation of future taxable income. We considered projected future taxable income, tax planning strategies, and reversal of taxable temporary differences in making this assessment. There has been no change in the established valuation allowance as of September 30, 2021. As of September 30, 2021 and December 31, 2020, we have recorded a net deferred tax liability of approximately $680,000 and $652,000, respectively.

We review and update our estimated annual effective tax rate each quarter. For the three months ended September 30, 2021 and 2020, we recorded an income tax benefit of $41,000 and income tax provision of $8,000 respectively. For the nine months ended September 30, 2021 and 2020, we recorded an income tax provision of $6,000 and income tax benefit of $136,000, respectively. For the three and nine months ended September 30, 2021 and 2020, our estimated effective rate was primarily impacted by the overall valuation allowance position which reduced the net tax impact from taxable income or loss for all periods.

Under the provisions of ASC 740, we determined that there were approximately $961,000 and $763,000 of gross unrecognized tax benefits as of September 30, 2021 and December 31, 2020, respectively. Included in the balance of unrecognized tax benefits as of September 30, 2021 and December 31, 2020 were $241,000 and $278,000, respectively, of tax benefits that, if recognized, would impact the effective tax rate. Also included in the balance of unrecognized tax benefits as of September 30, 2021 and December 31, 2020 were $720,000 and $485,000, respectively, of tax benefits that, if recognized, would not impact the effective tax rate due to the Company’s valuation allowance. The Company had accrued interest and penalties related to the unrecognized tax benefits of $238,000 and $241,000, which were recorded in other liabilities as of September 30, 2021 and December 31, 2020, respectively. We believe that the total amounts of unrecognized tax benefits will not significantly increase or decrease within the next 12 months.

**Note 11**. **Commitments and Contingencies**

*Legal Proceedings*

*Hamot et al. v. Telos Corporation*

As previously reported in Note 8 of the Form 10-Q for the quarter ended June 30, 2021 filed on August 16, 2021, beginning on August 2, 2007, Messrs. Seth W. Hamot (“Hamot”) and Andrew R. Siegel (“Siegel”), principals of Costa Brava Partnership III, L.P. (“Costa Brava”), were involved in litigation against the Company as Plaintiffs and Counter-defendants in the Circuit Court for Baltimore City, Maryland (the “Circuit Court”). Mr. Siegel was a Class D Director of the Company until the closing of the IPO on November 23, 2020, and Mr. Hamot was a Class D Director of the Company until his resignation on March 9, 2018. Trial on Hamot and Siegel’s claims and the Company’s counterclaims took place in July through September 2013, and the Court subsequently issued decisions on the various claims by way of memorandum opinions and orders dated September 11, 2017. Among other rulings, the Court found Hamot and Siegel liable for the intentional tort of tortious interference with the Company’s contractual relationship with one of its auditors and entered a monetary judgment in favor of the Company and against Hamot and Siegel.

Hamot (and later, his Estate) and Siegel on multiple occasions during this litigation sought to be indemnified or to be awarded advancement of various attorney’s fees and expenses incurred by them in this litigation. On January 28, 2021, Plaintiffs filed a Motion for Leave to File Amended Motion for Indemnification of Legal Fees and Expenses (“Amended Motion”). The Amended Motion demanded that the Company indemnify the Plaintiffs for legal fees and expenses incurred in the sum of $2,540,000 plus the costs incurred in obtaining indemnification, and the Company opposed the motions. On May 5, 2021, the Company, Plaintiffs and Costa Brava entered into a settlement agreement, which included a mutual general release, fully and finally settling the indemnification claim in exchange for a $1.0 million payment, which sum was paid on May 12, 2021 as reported under other income (expense) in our condensed consolidated statements of operations. This settlement concluded all open matters or disputes between the Company and Messrs. Hamot (or his estate) and Siegel, as well as the previously disposed of claims of Costa Brava.

*Other Litigation*

The Company may be a party to litigation from time to time 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 condensed consolidated financial position, results of operations or cash flows.

*Other - Government Contracts*

As a government contractor, we are subject to U.S. government audits and investigations relating to our operations, including claims for fines, penalties, and compensatory and damages. We believe the outcome of such ongoing government audits and investigations will not have a material impact on our results of operations, financial condition or cash flows.

In the performance of our contracts, we routinely request contract modifications that require additional funding from the customer. Most often, these requests are due to customer-directed changes in the scope of work. While we are entitle to recovery of these costs under our contracts, the administrative process with our customer may be protracted. Based on the circumstances, we periodically file requests for equitable adjustments ("REAs") that are sometimes converted into claims. In some cases, these requests are disputed by our customers. We believe our outstanding modifications, REAs and other claims will be resolved without material impact to our result of operations, financial conditions or cash flows.

**Note 12**. **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 $88,000 and $389,000 for the three and nine months ended September 30, 2021, respectively, and $193,000 and $517,000 for the three and nine months ended September 30, 2020, respectively. Additionally, Mr. Wood owned 73,562 and 682,502 shares of the Company’s common stock as of September 30, 2021 and December 31, 2020, respectively.

On March 31, 2015, the Company entered into the Porter Notes. At that time, Mr. Porter and Toxford Corporation, of which Mr. Porter controls as the co-trustee of the trust that is the sole stockholder of Toxford, owned 35.0% of our Class A Common Stock. Under the terms of the Porter Notes, Porter lent the Company $2.5 million on or about March 31, 2015. According to the original terms of the Porter Notes, the outstanding principal sum bore interest at the fixed rate of twelve percent (12%) per annum which would be payable in arrears in cash on the 20th day of each May, August, November and February, with the first interest payment date due on August 20, 2015. The Porter Notes did not call for amortization payments and were unsecured. The Porter Notes, in whole or in part, may be repaid at any time without premium or penalty. The unpaid principal, together with interest, was originally due and payable in full on July 1, 2017.

On April 18, 2017, we amended and restated the Porter Notes to reduce the interest rate from twelve percent (12%) to six percent (6%) per annum, to be accrued, and extended the maturity date from July 1, 2017 to July 25, 2022. Telos also entered into Intercreditor Agreements with Porter and EnCap, in which the Porter Notes were fully subordinated to the Credit Agreement and any subsequent senior lenders, and payments under the Porter Notes were permitted only if certain conditions were met. All other terms remained in full force and effect. We incurred interest expense in the amount of $90,000 and $265,000 for the three and nine months ended September 30, 2020, respectively, on the Porter Notes. On November 23, 2020, upon the closing of the IPO, the Porter Notes were paid in full.

On February 8, 2021, we hired Ms. Donna Hill, as Director, Human Resources, reporting directly to Ms. Nakazawa, EVP of the Company. Ms. Hill is the sister of Mr. Edward Williams, COO of the Company.

**Note 13. Leases**

The components of lease expense were as follows (in thousands):

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2021 | 2020 | 2021 | 2020 |
| Operating lease cost | $ 182 | $ 182 | $ 546 | $ 542 |
| Short-term lease cost[1] | 4 | 26 | 13 | 83 |
| Finance lease cost | | | | |
| Amortization of right-of-use assets | 305 | 305 | 915 | 915 |
| Interest on lease liabilities | 187 | 205 | 574 | 622 |
| Total finance lease cost | 492 | 510 | 1,489 | 1,537 |
| Total lease costs | $ 678 | $ 718 | $ 2,048 | $ 2,162 |

[1] Leases that have terms of 12 months or less

The weighted average remaining lease terms and discount rates were as follows:

| | September 30, | |
|---|---|---|
| | 2021 | 2020 |
| Weighted average remaining lease term (in years): | | |
| Finance leases | 7.6 years | 8.6 years |
| Operating leases | 1.9 years | 2.8 years |
| Weighted average discount rate: | | |
| Finance leases | 5.04 % | 5.04 % |
| Operating leases | 5.75 % | 5.75 % |

Future minimum lease commitments at September 30, 2021 were as follows (in thousands):

| Year Ending December 31, | Operating Leases | Finance Leases |
|---|---|---|
| 2021 (excluding the nine months ended September 30, 2021) | $ 181 | $ 530 |
| 2022 | 603 | 2,149 |
| 2023 | 373 | 2,202 |
| 2024 | 27 | 2,258 |
| 2025 | — | 2,314 |
| After 2025 | — | 8,344 |
| Total lease payments | 1,184 | 17,797 |
| Less imputed interest | (66) | (3,149) |
| Total | 1,118 | 14,648 |
| Less Short-term portion | 602 | 1,430 |
| Total, net of short-term portion | $ 516 | $ 13,218 |

Supplemental cash flow information related to leases was as follows (in thousands):

| | Nine Months Ended September 30, | |
|---|---|---|
| | 2021 | 2020 |
| Cash paid for amounts included in the measurement of lease liabilities: | | |
| Cash flows from operating activities - operating leases | $ 586 | $ 552 |
| Cash flows from operating activities - finance leases | 574 | 622 |
| Cash flows from financing activities - finance leases | 993 | 907 |
| Operating lease right-of-use assets obtained in exchange for lease obligations | 486 | 455 |

**Note 14 – Stock-Based Compensation**

During October 2020, the Company amended the 2016 LTIP to increase the total number of shares available for issuance to 9,400,000 from 4,500,000 and extend the term to September 30, 2030. Our 2016 LTIP provides for the grant of stock options, stock appreciation rights, restricted stock, restricted stock units, unrestricted stock and dividend equivalent rights 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 two to three years and stock options granted under the 2016 LTIP expire no more than ten years after the date of grant. Approximately 5.7 million shares of our common stock were reserved for future grants as of September 30, 2021 under the 2016 LTIP.

The following are the stock-based compensation expense incurred for the three and nine months ended September 30, 2021 (in thousands). We recorded immaterial share-based compensation expense for the comparative periods ended September 30, 2020.

| | Three Months Ended September 30, 2021 | Nine Months Ended September 30, 2021 |
|---|---|---|
| Cost of sales - services | $ 442 | $ 1,974 |
| Sales and marketing | 1,536 | 5,316 |
| Research and development | 970 | 2,079 |
| General and administrative | 9,243 | 37,828 |
| Total | $ 12,191 | $ 47,197 |

***Restricted Stock Awards and Restricted Stock Unit (collectively "RSU") Activity***

The Company grants RSUs to our senior executives, directors and employees.

*Service-Based RSU Awards*

A summary of the awards of Service-Based RSUs that vest upon the completion of a service requirement are presented below:

| | Number of Shares | Weighted-Average Grant Date Fair Value (per share) | Weighted-Average Contractual Life (years) | Aggregate Intrinsic Value (in thousands) |
|---|---|---|---|---|
| Unvested Balance - December 31, 2020 | 59,521 | $ 0.18 | 2.4 | $ 2,000 |
| Granted | 3,036,563 | 35.69 | — | — |
| Vested | (119,800) | 36.17 | — | — |
| Forfeited | (79,476) | 36.63 | — | — |
| Unvested Balance - September 30, 2021 | 2,896,808 | $ 35.04 | 1.5 | $ 82,300 |

We recognized an expense of $12.0 million and $34.0 million related to share-based compensation expense for Service-Based RSUs capable of being earned for completing a service requirement during the three and nine months ended September 30, 2021, respectively. As of September 30, 2021, there was approximately $71.5 million of unrecognized stock-based compensation expense related to Service-Based RSUs, and this unrecognized expense is expected to be recognized over a weighted-average period of 1.5 years on a straight-line basis.

*Performance-Based RSU Awards*

A summary of the awards of Performance-Based RSUs that vest upon the attainment of certain price targets of the Company's common stock are presented below:

| | Number of Shares | Weighted-Average Grant Date Fair Value (per share) | Weighted-Average Contractual Life (years) | Aggregate Intrinsic Value (in thousands) |
|---|---|---|---|---|
| Unvested Balance - December 31, 2020 | — | $ — | — | $ — |
| Granted | 508,903 | 30.09 | — | — |
| Vested | — | — | — | — |
| Forfeited | (16,176) | 30.84 | — | — |
| Unvested Balance - September 30, 2021 | 492,727 | $ 30.07 | 2.5 | $ 14,000 |

During 2021 the Company granted certain senior executives awards of Performance-Based RSUs that could settle in 458,903 shares of our common stock. The awards will vest only if, during the three-year period from the date of grant, (a) the Company's common stock, as listed on the Nasdaq Global Market, trades at or above $42.40 per share (the "Target Price") for 20 of 30 consecutive trading days or (b) the weighted average of the per share price of the Company's common stock over any 30 consecutive trading days is at least equal to the Target Price. Further, the Company granted 50,000 shares of Performance-Based RSUs to certain employees that will fully vest upon the achievement of certain operational milestones during a three-year period from the grant date.

For these Performance-Based RSUs containing market conditions, the conditions are required to be considered when calculating the grant date fair value. In order to reflect the substantive characteristics of these awards, a Monte Carlo simulation valuation model was used to calculate the grant date fair value of such awards. Monte Carlo approaches are a class of computational algorithms that rely on repeated random sampling to compute their results. This approach allows the calculation of the value of such Performance-Based RSUs based on a large number of possible stock price path scenarios. As the Company recently completed its IPO in November 2020, expected volatility was based on the average historical stock price volatility of comparable publicly-traded companies over the performance period. The risk-free rate is based on the U.S. treasury zero-coupon issues in effect at the time of grant over the performance period. Expense for these awards is recognized over the derived service period as determined through the Monte Carlo simulation model.

Our key assumptions include a performance period ranging from 2.45 to 2.92 years, expected volatility between 57.4% - 58.81%, and a risk-free rate of 0.18%-0.29%. The fair value at grant date and derived service periods calculated for these market condition Performance-Based RSUs were $19.12 - $30.84 and between 0.38 - 0.76 years, respectively.

We recognized an expense of $0.2 million and $13.2 million related to share-based compensation expense for these awards of Performance-Based RSUs during the three and nine months ended September 30, 2021, respectively. As of September 30, 2021, there was approximately $1.6 million of unrecognized stock-based compensation expense related to these Performance-Based RSUs, and this unrecognized expense is expected to be recognized over a weighted-average period of 0.3 years on a straight-line basis.

## 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, 2020, 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 ("ICT") 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 gives 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* – We help our customers ensure the ongoing security, integrity, and compliance of their on-premises and related cloud-based systems, reducing threats and vulnerabilities to foil cyber adversaries before they can attack. Our consultants assess our customers’ security environments and design, engineer, and operate the systems they need to strengthen their cybersecurity posture.

- *Cloud Security* – The cloud as an organizational resource is more than two decades old, yet the needs of cloud users are constantly changing. Telos offers the specialized skills and experience needed to help our customers plan, engineer, and execute secure cloud migration strategies and then assure ongoing management and security in keeping with the leading standards for cloud-based systems and workloads.

- *Enterprise Security* – Securing the enterprise means protecting the essential and timeless elements common to every organization: its people and processes, its supply chain and inventories, its finances and facilities, and its information and communications. As ICT and operational technology (“OT”) have become part of the organizational make-up, we have offered solutions that ensure personnel can work securely and productively across and beyond the enterprise.

We refer to our cyber and cloud applications as Security Solutions, which includes Information Assurance / Xacta® (previously referred to as Cyber & Cloud Solutions), Secure Communications (previously referred to as Secure Communications Cyber and Enterprise Solutions), and Telos ID (previously referred to as Telos ID Enterprise Solutions). We refer to our offerings for enterprise security as Secure Networks (previously referred to as Secure Mobility and Network Management/Defense Enterprise Solutions).

***Security Solutions***

- **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.

- **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 cyber-attack 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 DISA 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 SaaS 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. We maintain government certifications and designations that distinguish Telos ID, including TSA PreCheck® enrollment provider, Designated Aviation Channeling provider, FBI-approved Channeler, and FINRA Electronic Fingerprint Submission provider.

***Secure Networks***

- **Secure Mobility:** solutions for business and government that enable remote work and minimize concern 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 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. Due to delays in the passage of FY 2022 appropriations legislation, the federal government is operating under the terms of a Continuing Resolution ("CR"), which limits spending to the prior year’s funding levels and generally prohibits new spending initiatives and contract starts. The current CR will expire December 3, and unless the individual appropriations bills are enacted by then, another CR will be needed to avert a government shutdown.

***Cybersecurity Landscape***

Despite the massive shift to teleworking by federal employees and contractors as a result of the pandemic, the government has successfully maintained continuity of services. More recently, as the government has proceeded to develop and implement its reopening process, officials have said they will seek to continue to maximize use of teleworking by federal employees. As such, with much of the business of government still being conducted by federal employees working remotely using 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.

Over the past year, continued and increasingly damaging ransomware and other cyberattacks against federal, state and local government and K-12 education (SLED), and higher education, 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 SLED 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. 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 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 OT and industrial control systems (ICS) from the public internet to keep them from being compromised. It can also cordon off financial data, medical records, intellectual property, and other crown-jewel assets from visibility or accessibility by adversaries.

Government mandates and initiatives to assure stronger security in highly regulated industries also lead to opportunities for Xacta. A pending 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.

President Biden’s May 12 Executive Order on “Improving the Nation’s Cybersecurity” acknowledged the severity and scope of the cybersecurity challenges facing the public and private sectors, the American people and our economy. It gave direction for federal departments and agencies to modernize government cybersecurity by: moving more rapidly to adopt secure cloud services; adopting multifactor authentication; pushing for increased use in government of such practices as zero trust architecture; and improving the security and integrity of the software supply chain, with a priority on addressing critical software. The executive order also called for improving communications with cloud service providers through automation and standardization of messages at each stage of the Federal Risk and Authorization Management Program ("FedRAMP") process, and for other changes in an effort to accelerate and improve the process.

Subsequently, federal agencies, including the Cybersecurity & Infrastructure Security Agency and the Transportation Security Administration, which have specific responsibilities for various aspects of government and private sector cybersecurity, have taken steps to enhance public sector and critical infrastructure cybersecurity.

Congress has given final approval to a $1.2 trillion infrastructure package which contains a number of provisions dealing with cybersecurity and would provide considerable funding for infrastructure-related cybersecurity. We believe many of these actions could ultimately result in increased need for solutions and services provided by Telos. Congress is also considering a potentially $2 trillion budget reconciliation measure that could, among other things, also boost federal support for cybersecurity and provide additional opportunities for Telos.

For example, Telos Ghost is a perfect complement to zero trust security, creating an additional layer of defense against intruders by hiding critical resources and users in an anonymous undiscoverable network. As noted earlier, it is also ideal for protecting the crown-jewel assets of critical infrastructure from unauthorized access. Xacta streamlines and automates the critical processes of the leading cybersecurity standards and frameworks, in particular 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.

Finally, as a whole, the COVID-19 pandemic has resulted in acceleration of digital transformation and cloud adoption within the government and beyond, which will likely increase demand for Xacta and Telos Ghost. Xacta is engineered to manage risk and compliance of complex cloud and multi-cloud environments, a key capability for federal agencies and regulated industries that need to gain and maintain compliance with cloud-specific security regulations. Telos Ghost is a cloud-native, as-as-service offering that delivers network obfuscation and managed attribution capabilities on a global scale to support the cloud-enabled enterprise.

### *COVID-19 Pandemic*

The coronavirus disease 2019 ("COVID-19") pandemic has caused a disruption of the normal operations of many businesses, including the temporary closure or scale-back of business operations and/or the imposition of either quarantine or remote work or meeting requirements for employees, either by government order or on a voluntary basis.

The ongoing pandemic may adversely affect our customers’ ability to perform their missions and is in many cases disrupting their operations. It may also impact the ability of our subcontractors, partners, and suppliers to operate and fulfill their contractual obligations, and result in an increase in their costs and cause delays in performance. These supply chain effects, and the direct effect of the virus and the disruption on our operations, may negatively impact both our ability to meet customer demand and our revenue and profit margins. Our employees, in some cases, are working remotely due either to safety concerns or to customer imposed limitations and using various technologies to perform their functions. On September 24, 2021, Executive Order 14042 on Ensuring Adequate COVID Safety Protocols for Federal Contractors was issued requiring, amongst other things, all employees, sub-contractors and vendors working on certain federal contracts or who do work related to these federal contracts be fully vaccinated by December 8, 2021. While that deadline to be fully vaccinated has been pushed back to January 18, 2022, this new requirement may negatively impact our ability to hire and retain talent, and to utilize certain sub-contractors and/or vendors to meet our customer demands and/or contractual requirements.

Additionally, the disruption and volatility in the global and domestic capital markets may increase the cost of capital and limit our ability to access capital. Both the health and economic aspects of COVID-19 are highly fluid and the future course of each is uncertain.

### 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. In the context of our current customer portfolio, we view “recurring revenue” as revenue that occurs often and repeatedly. In each of the last three years, recurring revenue has exceeded 85% of our annual revenue.

Total backlog, a component of recurring revenue, 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.

**Consolidated Results of Operations (Unaudited)**

The following table sets forth selected data as a percentage of sales for the three and nine months ended September 30, 2021 and 2020 are as follows:

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2021 | 2020 | 2021 | 2020 |
| | (unaudited) | | (unaudited) | |
| Revenue | 100.0 % | 100.0% | 100.0% | 100.0% |
| Cost of sales | 62.8 | 65.1 | 65.8 | 65.7 |
| Selling, general and administrative expenses | 44.7 | 25.4 | 55.1 | 26.9 |
| Operating (loss) income | (7.5) | 9.5 | (20.9) | 7.4 |
| Other income (expense) | — | — | (0.6) | — |
| Interest expense | (0.2) | (4.2) | (0.3) | (4.5) |
| (Loss) income before income taxes | (7.7) | 5.3 | (21.8) | 2.9 |
| Benefit from (provision for) income taxes | — | — | — | 0.1 |
| Net (loss) income | (7.7) | 5.3 | (21.8) | 3.0 |
| Less: Net income attributable to non-controlling interest | — | (5.7) | — | (4.6) |
| Net loss attributable to Telos Corporation | (7.7)% | (0.4)% | (21.8)% | (1.6)% |

***Three Months Ended September 30, 2021 Compared with Three Months Ended September 30, 2020***

Revenue increased by 47.7% to $70.1 million for the third quarter of 2021, from $47.4 million for the same period in 2020. Revenue for the third quarter, excluding the contract with the U.S. Census Bureau of $1.6 million in 2021 and $9.4 million in 2020, would have grown by 79.9% in the current quarter compared with prior year same period. Security Solutions revenue was $35.7 million and $31.2 million for the third quarter of 2021 and 2020, respectively. This increase of approximately 14.4% was driven primarily by the increases in sales of Telos ID and Information Assurance offerings, offset by the decrease in Secure Communications offerings. Secure Networks revenue was $34.4 million and $16.2 million for the third quarter of 2021 and 2020, respectively. This increase of approximately 112.3% resulted from various contracts with the DoD, primarily in our Secure Mobility Solutions offerings. Due to the various solutions 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 42.5% to $44.0 million for the third quarter of 2021, from $30.9 million for the same period in 2020 as a result of increases in revenue. Cost of sales for Security Solutions decreased to $15.3 million (inclusive of $0.4 million of stock-based compensation) for the third quarter of 2021 from $17.2 million for the same period in 2020 (which had no stock-based compensation), which translates as a decrease in the cost of sales as a percentage of revenue to 42.9% from 55.1%, due to a change in the mix and nature of the programs. Cost of sales for Secure Networks increased to $28.7 million (inclusive of $0.1 million stock-based compensation) for the third quarter of 2021 from $13.7 million for the same period in 2020 (which had no stock-based compensation). While the cost of sales increased between periods, the sales mix improved, which translates to a decrease in the cost of sales as a percentage of revenue to 83.4% from 84.6%.

Gross profit increased by 57.4% to $26.1 million for the third quarter of 2021 from $16.6 million for the same period in 2020. Gross profit for Security Solutions increased to $20.4 million for the third quarter of 2021 from $14.0 million for the same period in 2020. Gross profit for Secure Networks increased to $5.7 million for the third quarter of 2021 from $2.6 million for the same period in 2020. Gross margin increased to 37.2% for the third quarter of 2021 from 34.9% for the same period in 2020, due to various changes in the mix of higher profit margin contracts in all business lines as discussed above. Gross margin for Security Solutions increased to 57.1% for the third quarter of 2021 from 44.9% for the same period in 2020. Gross margin for Secure Networks increased to 16.6% for the third quarter of 2021 from 15.8% for the same period in 2020.

Selling, general, and administrative (“SG&A”) expense increased by 160.0% to $31.3 million for the third quarter of 2021, from $12.0 million for the same period in 2020, primarily attributable to increases in stock-based compensation of $11.8 million, labor costs of $5.5 million, and outside services of $1.2 million.

Operating loss was $5.3 million for the third quarter of 2021, compared to $4.5 million operating income for the same period in 2020, primarily due to the stock-based compensation expense related to the RSUs granted in fiscal year 2021.

Interest expense decreased by 90.3% to $0.2 million for the third quarter of 2021, from $2.0 million for the same period in 2020, primarily due to the repayment of the EnCap loan, subordinated debt, and redemption of public preferred stock upon the closing of our IPO in November 2020.

Income tax benefit was $41,000 for the third quarter of 2021, compared to $8,000 income tax provision for the same period in 2020, which is based on the estimated annual effective tax rate applied to the pretax loss incurred for the quarter plus discreet tax items, based on our expectation of pretax loss for the fiscal year.

Net loss attributable to Telos Corporation was $5.4 million for the third quarter of 2021, compared to $0.2 million for the same period in 2020, primarily due to the stock-based compensation recorded in the third quarter of 2021 as mentioned above.

***Nine Months Ended September 30, 2021 Compared with Nine Months Ended September 30, 2020***

Revenue increased by 32.1% to $178.4 million for the nine months ended September 30, 2021, from $135.0 million for the same period in 2020. Revenue, excluding the contract with the U.S. Census Bureau of $4.2 million in 2021 and $29.9 million in 2020, would have grown by 65.8% year-over-year. Security Solutions revenue was $89.7 million and $92.5 million for the nine months ended September 30, 2021 and 2020, respectively. This decrease of approximately 3.0% was driven primarily by decreases in sales of offerings in Telos ID, as the Census contract ramps down, and Secure Communication offerings, offset by an increase in Information Assurance offerings. Secure Networks revenue was $88.7 million and $42.5 million for the nine months ended September 30, 2021 and 2020, respectively. This increase of approximately 108.7% resulted from various contracts with the DoD, primarily in our Secure Mobility Solutions offerings. Due to the various solutions 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 32.4% to $117.4 million for the nine months ended September 30, 2021, from $88.7 million for the same period in 2020 as a result of increases in revenue. Cost of sales for Security Solutions decreased to $44.5 million (inclusive of $1.7 million of stock-based compensation) for the nine months ended September 30, 2021 from $53.8 million for the same period in 2020 (which had no stock-based compensation), which translates as a decrease in the cost of sales as a percentage of revenue to 49.6% from 58.2%, due to a change in the mix and nature of the programs. Cost of sales for Secure Networks increased to $72.9 million (inclusive of $0.3 million of stock-based compensation) for the nine months ended September 30, 2021 from $34.9 million for the same period in 2020 (which had no stock-based compensation), which translates as an increase in the cost of sales as a percentage of revenue to 82.2% from 82.1%.

Gross profit increased by 31.5% to $61.0 million for the nine months ended September 30, 2021 from $46.4 million for the same period in 2020. Gross profit for Security Solutions increased to $45.2 million for the nine months ended September 30, 2021 from $38.7 million for the nine months ended September 30, 2020. Gross profit for Secure Networks increased to $15.8 million for the nine months ended September 30, 2021 from $7.6 million for the nine months ended September 30, 2020. Gross margin decreased to 34.2% as of the third quarter of 2021 from 34.3% for the same period in 2020, due to various changes in the mix of contracts in all business lines as discussed above. Gross margin for Security Solutions increased to 50.4% as of the third quarter of 2021 from 41.8% for the same period in 2020. Gross margin for Secure Networks decreased to 17.8% as of the third quarter of 2021 from 17.9% for the same period in 2020.

SG&A expense increased by 170.1% to $98.3 million for the nine months ended September 30, 2021, from $36.4 million for the same period in 2020, primarily attributable to increases in stock-based compensation of $45.2 million, labor costs of $11.9 million, outside services of $3.2 million, insurance costs of $1.0 million, and trade show costs of $1.1 million, offset by the decrease in bonus costs of $1.6 million.

Operating loss was $37.3 million for the nine months ended September 30, 2021, compared to $10.0 million of operating income for the same period in 2020, primarily due to the stock-based compensation recorded as of the third quarter of 2021 as mentioned above.

Other expense for the nine months ended September 30, 2021 was $1.0 million compared to $14,000 of other income for the nine months ended September 30, 2020 was as a result of the settlement of outstanding litigation.

Interest expense decreased by 90.3% to $0.6 million for the nine months ended September 30, 2021, from $6.0 million for the same period in 2020, primarily due to the repayment of the EnCap loan, subordinated debt, and redemption of public preferred stock upon the closing of our IPO in November 2020.

Income tax provision was $6,000 for the nine months ended September 30, 2021, compared to $136,000 income tax benefit for the same period in 2020, which is based on the estimated annual effective tax rate applied to the pretax loss incurred for the nine months period plus discreet tax items, based on our expectation of pretax loss for the fiscal year.

Net loss attributable to Telos Corporation was $38.9 million for the nine months ended September 30, 2021, compared to $2.2 million for the same period in 2020, primarily attributable to the stock-based compensation recorded in 2021 as mentioned above.

**Balance Sheet Review**

***Assets***

The Company's total assets as of September 30, 2021 were $242.7 million compared to $183.8 million as of December 31, 2020. The increase in total assets was primarily attributable to an increase in cash and cash equivalents provided by the follow-on offering, an increase in accounts receivables due to higher revenue generation and increase in intangible assets and goodwill as a result of the acquisition during the nine months ended September 30, 2021.

***Liabilities***

The Company's total liabilities as of September 30, 2021 were $71.2 million compared to $56.7 million as of December 31, 2020. The increase in total liabilities was primarily attributable to the increase in accounts payable and other accrued liabilities as a result of the increase in cost of sales as of September 30, 2021.

***Equity***

As of September 30, 2021, the Company had a total equity of $171.5 million compared to $127.1 million as of December 31, 2020. The increase in equity is primarily driven by the follow-on offering that raised $64.3 million and stock-based compensation of $47.2 million; offset by the repurchase of the common stock and outstanding warrants held by EnCap for $1.3 million and $26.9 million, respectively. The Company reported a net loss of $38.9 million for the nine months ended September 30, 2021.

**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 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 disproportionate 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 do not represent, and should not be considered as, an alternative to net loss as determined by GAAP. We define Enterprise EBITDA as net loss attributable to Telos Corporation, adjusted for net income attributable to non-controlling interest, non-operating (income) expense, interest expense, provision for (benefit from) income taxes, and depreciation and amortization. We define Adjusted EBITDA as Enterprise EBITDA, adjusted for transaction gains/losses/expenses related to our IPO and stock-based compensation expense.

A reconciliation of net loss attributable to Telos Corporation to Enterprise EBITDA and Adjusted EBITDA, the most directly comparable GAAP measure, is as follows (in thousands):

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | **2021** | **2020** | **2021** | **2020** |
| Net loss attributable to Telos Corporation | $ (5,387) | $ (200) | $ (38,894) | $ (2,178) |
| Adjustments: | | | | |
| Net income attributable to non-controlling interest | — | 2,694 | — | 6,284 |
| Non-operating (income) expense | (20) | (2) | 1,001 | (14) |
| Interest expense | 195 | 2,013 | 583 | 6,026 |
| (Benefit from) provision for income taxes | (41) | 8 | 6 | (136) |
| Depreciation and amortization | 1,459 | 1,284 | 4,223 | 4,018 |
| Enterprise EBITDA | (3,794) | 5,797 | (33,081) | 14,000 |
| Stock-based compensation expense | 12,191 | 4 | 47,197 | 4 |
| Adjusted EBITDA | $ 8,397 | $ 5,801 | $ 14,116 | $ 14,004 |

***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 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) attributable to Telos Corporation, 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.

A reconciliation of net loss attributable to Telos Corporation to Adjusted Net Income (Loss) and Adjusted EPS, the most directly comparable GAAP measure, is as follows:

| ***Three Months Ended September 30,*** | **2021** | | **2020** | |
|---|---|---|---|---|
| | **Adjusted Net Income (Loss)** | **Adjusted Earnings Per Share** | **Adjusted Net Income (Loss)** | **Adjusted Earnings Per Share** |
| | (in thousands) | | (in thousands) | |
| Reported GAAP measure | $ (5,387) | $ (0.08) | $ (200) | $ (0.01) |
| Adjustments: | | | | |
| Non-operating income | (20) | — | (2) | — |
| Stock-based compensation expense | 12,191 | 0.18 | 4 | — |
| Adjusted non-GAAP measure | $ 6,784 | $ 0.10 | $ (198) | $ (0.01) |
| Weighted-average shares of common stock outstanding | 66,755 | | 39,002 | |

| *Nine Months Ended September 30,* | 2021 | | 2020 | |
|---|---|---|---|---|
| | **Adjusted Net Income (Loss)** | **Adjusted Earnings Per Share** | **Adjusted Net Income (Loss)** | **Adjusted Earnings Per Share** |
| | (in thousands) | | (in thousands) | |
| Reported GAAP measure | $ (38,894) | $ (0.59) | $ (2,178) | $ (0.06) |
| Adjustments: | | | | |
| Non-operating expense (income) | 1,001 | 0.01 | (14) | — |
| Stock-based compensation expense | 47,197 | 0.72 | 4 | — |
| Adjusted non-GAAP measure | $ 9,304 | $ 0.14 | $ (2,188) | $ (0.06) |
| Weighted-average shares of common stock outstanding | 65,999 | | 38,554 | |

***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 capital expenditure and adjusted for the final distribution to Telos ID Class B members included in cash from operating activities. 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 assess the quality of our earnings as a key performance measure in evaluating management.

| *Nine Months Ended September 30,* | 2021 | 2020 |
|---|---|---|
| | (in thousands) | (in thousands) |
| Net cash flows provided by operating activities | $ 6,668 | $ 11,957 |
| Adjustments: | | |
| Capital expenditure | (7,784) | (6,083) |
| Final distribution to Telos ID Class B member - included in cash from operating activities | 2,436 | — |
| Free cash flow | $ 1,320 | $ 5,874 |

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 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 Adjusted EBITDA, Adjusted Net Income (Loss), Adjusted EPS and Free Cash Flow differently than we do, which limits its 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 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 ERPS Conversion (see Note 9 – Exchangeable Redeemable Preferred Stock Conversion), $30.0 million to fund our acquisition of the outstanding Class B Units of Telos ID (see Note 3 – Non-controlling Interests / Purchase of Telos ID), and $21.0 million to repay our outstanding senior term loan and subordinated debt (see Note 8 – Debt Obligations).

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 warrants to purchase 900,970 shares our common stock owned by EnCap (see Note 8 - Debt Obligations). Further, on July 30, 2021, we used approximately $5.9 million of the net proceeds to acquire the assets of DFT (see Note 4 - Acquisition).

We intend to use the remaining net proceeds of the IPO and the follow-on offering for general corporate purposes. We also may use a portion of the net proceeds to acquire complementary businesses, products, services, or technologies. The amounts and timing of our actual use of the net proceeds will vary depending on numerous factors. Proceeds held by us is invested in short-term investments until needed for the uses described above.

Our working capital was $137.9 million and $105.2 million as of September 30, 2021 and December 31, 2020, respectively. Although no assurances can be given, we expect our current sources of liquidity are sufficient to support our operating, investing and financing needs for the next 12 months.

We ended the third quarter of 2021 with a cash and cash equivalent balance of $134.1 million compared to $106.0 million at the end of 2020. We believe we have adequate funds on hand to execute our financial and operating strategy. The following is a discussion of our major operating, investing and financing activities in the first nine months of 2021 and 2020, as classified on the Condensed Statements of Cash Flows in Part I, Item 1.

Cash provided by operating activities was $6.7 million for the nine months ended September 30, 2021, compared to cash provided by operating activities of $12.0 million for the same period in 2020. Cash provided by or used in operating activities is primarily driven by the timing of receipt of customer payments, the timing of payments to vendors and employees, and the timing of inventory turnover.

Cash used in investing activities was approximately $13.7 million and $6.1 million for the nine months ended September 30, 2021 and 2020, respectively, primarily driven by the $5.9 million of cash paid for the acquisition completed in July 2021 (see Note 4 - Acquisition).

Cash provided by financing activities was $35.1 million for the nine months ended September 30, 2021 compared to cash used in financing activities of $2.3 million for the same period in 2020, primarily attributable to the proceeds from the follow-on offering that generated $64.3 million of net proceeds, reduced by $26.9 million used to repurchase the outstanding warrants and $1.3 million to repurchase the common stock held by EnCap.

**Recent Accounting Pronouncements**

See Note 1 of the Condensed Consolidated Financial Statements for a discussion of recently issued accounting pronouncements.

**Critical Accounting Policies**

During the three months ended September 30, 2021, there were no material changes to our critical accounting policies as reported in our Annual Report on Form 10-K for the year ended December 31, 2020 as filed with the SEC on March 25, 2021.

**Item 3. Quantitative and Qualitative Disclosures about Market Risk**

None.

## Item 4. Controls and Procedures

***Evaluation of Disclosure Controls and Procedures***

An evaluation of the effectiveness of our disclosure controls and procedures as of September 30, 2021 was performed under the supervision and with the participation of our management, including the Chief Executive Officer and Chief Financial Officer. Based on that evaluation, our Chief Executive Officer and Chief Financial Officer have concluded that our disclosure controls and procedures are effective to ensure that information required to be disclosed by the Company in its reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission rules and forms, and that information required to be disclosed by the Company in the reports the Company files or submits under the Exchange Act is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure.

***Internal Control over Financial Reporting***

There has been no change in our internal control over financial reporting during the quarter ended September 30, 2021 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 11 – Commitments and Contingencies to the condensed consolidated financial statements.

### Item 1A. Risk Factors

There were no material changes in the period ended September 30, 2021 in our risk factors as disclosed in our Annual Report on Form 10-K for the year ended December 31, 2020.

### 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**
None.

### Item 3. Defaults upon Senior Securities

None.

### Item 4. Mine Safety Disclosures

Not applicable.

### Item 5. Other Information

None.

**Item 6. Exhibits**

| Exhibit Number | 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* | Certification pursuant to 18 U.S.C. Section 1350, as Adopted 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 Document |
| 101.CAL | XBRL Taxonomy Extension Calculation Linkbase Document |
| 101.DEF | XBRL Taxonomy Extension Definition Linkbase Document |
| 101.LAB | XBRL Taxonomy Extension Label Linkbase Document |
| 101.PRE | XBRL Taxonomy Extension Presentation Linkbase Document |
| 104 | Cover Page Interactive Data File - the cover page iXBRL tags are embedded within the Inline XBRL document contained in Exhibit 101 |

* filed or 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.

| | |
|---|---|
| Date: November 15, 2021 | TELOS CORPORATION |
| | /s/ John B. Wood |
| | John B. Wood<br>Chief Executive Officer (Principal Executive Officer) |
| | /s/ Mark Bendza |
| | Mark Bendza<br>Chief Financial Officer (Principal Financial and 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 and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and to the audit committee of registrant's board of directors:

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: November 15, 2021

/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 and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and to the audit committee of registrant's board of directors:

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: November 15, 2021

/s/ Mark Bendza

Mark Bendza
Chief Financial Officer (Principal Financial and Accounting 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 September 30, 2021, 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: November 15, 2021

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

Date: November 15, 2021

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