

ZIX CORP
Form 10-Q
November 07, 2012

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2012

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

For the transition period from to

Commission File Number: 0-17995

ZIX CORPORATION

(Exact Name of Registrant as Specified in its Charter)

Texas
(State of Incorporation)

75-2216818
(I.R.S. Employer

Identification Number)

2711 North Haskell Avenue

Suite 2200, LB 36

Dallas, Texas 75204-2960

(Address of Principal Executive Offices)

(214) 370-2000

(Registrant's Telephone Number, Including Area Code)

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

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

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Large accelerated filer Accelerated filer

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

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

Class	Outstanding at November 2, 2012
Common Stock, par value \$0.01 per share	61,264,533

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ZIX CORPORATION
CONDENSED CONSOLIDATED BALANCE SHEETS

	September 30, 2012 (unaudited)	December 31, 2011
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 23,031,000	\$ 20,680,000
Receivables, net	1,156,000	704,000
Prepaid and other current assets	1,233,000	1,422,000
Deferred tax assets	1,490,000	1,551,000
Total current assets	26,910,000	24,357,000
Property and equipment, net	2,275,000	2,228,000
Goodwill	2,161,000	2,161,000
Deferred tax assets	48,785,000	48,806,000
Total assets	\$ 80,131,000	\$ 77,552,000
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	\$ 456,000	\$ 396,000
Accrued expenses	2,817,000	1,896,000
Deferred revenue	19,193,000	16,568,000
Total current liabilities	22,466,000	18,860,000
Long-term liabilities:		
Deferred revenue	690,000	795,000
Deferred rent	93,000	140,000
Total long-term liabilities	783,000	935,000
Total liabilities	23,249,000	19,795,000
Commitments and contingencies (see Note 7)		
Stockholders' equity:		
Preferred stock, \$1 par value, 10,000,000 shares authorized; none issued and outstanding		
Common stock, \$0.01 par value, 175,000,000 shares authorized; 73,165,433 issued and 61,264,533 outstanding at September 30, 2012 and 72,639,465 issued and 63,819,531 outstanding at December 31, 2011	728,000	726,000
Additional paid-in capital	355,375,000	354,265,000
Treasury stock, at cost; 11,900,900 common shares at September 30, 2012 and 8,819,934 common shares at December 31, 2011	(41,506,000)	(32,506,000)
Accumulated deficit	(257,715,000)	(264,728,000)
Total stockholders' equity	56,882,000	57,757,000
Total liabilities and stockholders' equity	\$ 80,131,000	\$ 77,552,000

See notes to condensed consolidated financial statements.

ZIX CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Revenues	\$ 11,023,000	\$ 9,558,000	\$ 31,667,000	\$ 28,260,000
Cost of revenues	1,887,000	1,789,000	5,554,000	5,362,000
Gross margin	9,136,000	7,769,000	26,113,000	22,898,000
Operating expenses:				
Research and development	2,046,000	1,343,000	4,988,000	3,948,000
Selling, general and administrative	5,020,000	3,754,000	13,720,000	11,310,000
Total operating expenses	7,066,000	5,097,000	18,708,000	15,258,000
Operating income	2,070,000	2,672,000	7,405,000	7,640,000
Other income, net	6,000	18,000	16,000	79,000
Income before income taxes	2,076,000	2,690,000	7,421,000	7,719,000
Income tax benefit (expense)	(133,000)	(119,000)	(409,000)	(132,000)
Net Income	\$ 1,943,000	\$ 2,571,000	\$ 7,012,000	\$ 7,587,000
Basic income per common share	\$ 0.03	\$ 0.04	\$ 0.11	\$ 0.12
Diluted income per common share	\$ 0.03	\$ 0.04	\$ 0.11	\$ 0.11
Basic weighted average common shares outstanding	60,896,042	64,140,926	61,671,214	65,499,763
Diluted weighted average common shares outstanding	61,472,352	65,927,794	62,316,809	67,727,404

See notes to condensed consolidated financial statements.

ZIX CORPORATION

CONDENSED CONSOLIDATED STATEMENT OF STOCKHOLDERS EQUITY

(Unaudited)

	Stockholders Equity				Accumulated Deficit	Total Stockholders Equity
	Common Stock		Paid-In Capital	Treasury Stock		
	Shares	Amount				
Balance, December 31, 2011	72,639,465	\$ 726,000	\$ 354,265,000	\$ (32,506,000)	\$ (264,728,000)	\$ 57,757,000
Issuance of common stock upon exercise of stock options	174,968	2,000	306,000			308,000
Issuance of restricted common stock	351,000					
Employee stock-based compensation costs			796,000			796,000
Non-employee stock-based compensation costs			8,000			8,000
Repurchase of common stock				(9,000,000)		(9,000,000)
Net income					7,012,000	7,012,000
Balance, September 30, 2012	73,165,433	\$ 728,000	\$ 355,375,000	\$ (41,506,000)	\$ (257,715,000)	\$ 56,882,000

See notes to condensed consolidated financial statements.

ZIX CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

	Nine Months Ended September 30,	
	2012	2011
Operating activities:		
Net income	\$ 7,012,000	\$ 7,587,000
Non-cash items in net income:		
Depreciation and amortization	988,000	1,020,000
Employee stock-based compensation costs	796,000	369,000
Non-employee stock-based compensation costs	8,000	44,000
Changes in deferred taxes	82,000	3,000
Changes in operating assets and liabilities:		
Receivables	(452,000)	453,000
Prepaid and other assets	189,000	133,000
Accounts payable	75,000	(272,000)
Deferred revenue	2,520,000	1,321,000
Accrued and other liabilities	874,000	3,000
Net cash provided by operating activities	12,092,000	10,661,000
Investing activities:		
Purchases of property and equipment	(1,049,000)	(1,103,000)
Purchase of commercial paper		(2,290,000)
Net cash used in investing activities	(1,049,000)	(3,393,000)
Financing activities:		
Proceeds from exercise of stock options	308,000	1,778,000
Proceeds from exercise of warrants		1,259,000
Payment of license subscription note payable		(186,000)
Purchase of treasury shares	(9,000,000)	(15,000,000)
Net cash used by financing activities	(8,692,000)	(12,149,000)
Increase (decrease) in cash and cash equivalents	2,351,000	(4,881,000)
Cash and cash equivalents, beginning of period	20,680,000	24,619,000
Cash and cash equivalents, end of period	\$ 23,031,000	\$ 19,738,000

See notes to condensed consolidated financial statements.

ZIX CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

1. Basis of Presentation

The accompanying condensed consolidated financial statements of Zix Corporation (ZixCorp, the Company, we, our, us) should be read in conjunction with the audited consolidated financial statements included in the Company's 2011 Annual Report on Form 10-K. These financial statements are unaudited, but have been prepared in the ordinary course of business for the purpose of providing information with respect to the covered interim periods. Management of the Company believes that all adjustments necessary for a fair presentation of such periods have been included and are of a normal recurring nature. The results of operations for the nine month period ended September 30, 2012, are not necessarily indicative of the results to be expected for any future interim periods or for the full fiscal year.

2. Recent Accounting Standards and Pronouncements

Testing for Goodwill Impairment

In September 2011, the Financial Accounting Standards Board (FASB) amended guidance on testing goodwill for impairment. Under the new guidance, entities testing goodwill for impairment have the option of performing a qualitative assessment before calculating the fair value of a reporting unit in step 1 of the goodwill impairment test. If entities determine, on the basis of qualitative factors, that the fair value of a reporting unit is more likely than not less than the carrying value amount, the two-step impairment test would be required. Otherwise, further testing would not be needed. The new guidance does not change how goodwill is calculated, nor does it revise the requirement to test goodwill annually for impairment or between tests if events or circumstances warrant. The amended guidance became effective for us on January 1, 2012. This new guidance did not have an impact on our condensed consolidated financial statements.

Presentation of Other Comprehensive Income

In June 2011, the FASB issued guidance that requires entities to report components of comprehensive income in either a continuous statement of comprehensive income or two separate but consecutive statements. The guidance removes the option to present the components of other comprehensive income (OCI) as part of the statement of stockholders' equity. This guidance became effective for us for January 1, 2012, and must be applied retrospectively for all periods presented in the financial statements. The new guidance does not apply to entities that have no items of OCI in any period presented. This new guidance did not have an impact on our condensed consolidated financial statements.

3. Stock- Based Awards and Stock-Based Employee Compensation Expense

On April 13, 2012, the Company's Board of Directors adopted the Zix Corporation 2012 Incentive Plan (the 2012 Plan). The 2012 Plan was approved by the Company's shareholders at the annual meeting held on June 6, 2012. Under the terms of the 2012 Plan, 2,700,000 shares are available for issuance, plus a number of additional shares (not to exceed 1,327,000) underlying options outstanding under certain of the Company's prior equity plans that thereafter terminate or expire unexercised, or are cancelled, forfeited, or lapse for any reason. See Proposal 4 Approval of 2012 Incentive Plan contained in the Company's Definitive Proxy Statement on Schedule 14A (File No. 000-17995) filed with the Securities and Exchange Commission on April 27, 2012, for additional information regarding the 2012 Plan.

As of September 30, 2012, there were 7,670,947 options outstanding and 1,415,000 shares available for grant.

Stock Option Activity

There were 32,600 and 174,968 stock options exercised for the three and nine month periods ended September 30, 2012, respectively. There were 84,783 and 720,374 stock options exercised for the three and nine month periods ended September 30, 2011, respectively. There was a \$9,000 excess tax benefit recorded in the three month period ended September 30, 2012, related to the 32,600 options exercises. The excess tax benefit recorded in the nine month period ended September 30, 2012, related to the 174,968 option exercises was \$10,000. A deferred tax asset totaling \$219,000 and \$120,000, resulting from stock-based compensation expense associated with options relating to the Company's U.S. operations, was recorded for the nine month periods ended September 30, 2012 and 2011, respectively.

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The following is a summary of all stock option transactions during the three months ended September 30, 2012:

	Options	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term (Yrs)	Aggregate Intrinsic Value
Outstanding at June 30, 2012	7,169,547	\$ 4.41		
Granted at market price	589,000	\$ 2.50		
Cancelled or expired	(55,000)	\$ 3.54		
Exercised	(32,600)	\$ 1.74		
Outstanding at September 30, 2012	7,670,947	\$ 4.28	4.72	\$ 2,129,000
Options exercisable at September 30, 2012	6,261,948	\$ 4.60	3.69	\$ 1,833,000

Of the above-described stock options outstanding at September 30, 2012, 2,297,052 of such stock options outstanding had an exercise price lower than the market price of the Company's common stock.

For additional information regarding the Company's Stock Options and Stock-based Employee Compensation, see Note 4 to the consolidated financial statements contained in our Annual Report on Form 10-K for the fiscal year ended December 31, 2011.

Restricted Stock Activity

The following is a summary of all restricted stock activity during the three months ended September 30, 2012:

	Restricted Shares	Weighted Average Fair Value
Outstanding at June 30, 2012		
Granted at market price	351,000	\$ 2.49
Vested		
Cancelled		
Unvested restricted stock at September 30, 2012	351,000	\$ 2.49

Restricted Stock Unit Activity

The following is a summary of all restricted stock unit (RSU) activity during the three months ended September 30, 2012:

	Restricted Stock Units	Weighted Average Fair Value
Non-vested at June 30, 2012		
Granted at market price	113,000	\$ 2.49
Vested		
Cancelled		
Unvested restricted stock units at September 30, 2012	113,000	\$ 2.49

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The weighted average grant-date fair value of awards of restricted stock and RSU s (collectively restricted stock) is based on the quoted market price of the Company s common stock on the date of grant.

Stock-Based Compensation Expense

For the three and nine month periods ended September 30, 2012, the total stock-based employee compensation expense resulting from stock options, restricted stock, and RSU s was recorded to the following line items of the Company s condensed consolidated statements of operations:

	Three Months Ended September 30, 2012	Nine Months Ended September 30, 2012
Cost of revenues	\$ 38,000	\$ 94,000
Research and development	44,000	91,000
Selling, general and administrative	255,000	611,000
Stock-based compensation expense	\$ 337,000	\$ 796,000

As of September 30, 2012, there was \$3,467,000 of total unrecognized stock-based compensation related to non-vested stock-based compensation awards granted under the incentive plans. This cost is expected to be recognized over a weighted average period of 1.75 years.

4. Supplemental Cash Flow Information

Supplemental cash flow information relating to interest, taxes and non-cash activities:

	Nine Months Ended September 30,	
	2012	2011
Cash paid for interest	\$	\$ 7,000
Cash income tax payments	\$ 295,000	\$ 172,000
Non-cash investing and financing activities:		
Payables related to purchases of fixed assets	\$ 14,000	\$ 96,000

5. Receivables, net

	September 30, 2012	December 31, 2011
Receivables	\$ 1,192,000	\$ 711,000
Allowance for returns and doubtful accounts	(36,000)	(7,000)
Note receivable	458,000	458,000
Allowance for note receivable	(458,000)	(458,000)
Receivables, net	\$ 1,156,000	\$ 704,000

The allowance for doubtful accounts includes all specific accounts receivable which we believe are likely not collectible based on known information. In addition, we record 2.5% of all accounts receivable greater than 90 days past due, net of those accounts specifically reserved, as a general allowance against accounts that could potentially become uncollectible.

The note receivable represents the remaining outstanding balance of an original note related to the sale of a product line in 2005 in the amount of \$540,000. This was fully reserved at the time of the sale as the note's collectability was not assured. The note receivable is fully reserved at September 30, 2012.

6. Earnings Per Share and Potential Dilution

Basic earnings per share are computed using the weighted average number of common shares outstanding for the period. The dilutive effect of common shares potentially outstanding is included in diluted earnings per share. The computations for basic and diluted earnings per share for the three and nine month periods ended September 30, 2012 and 2011, are as follows:

	Three Months ended September 30,		Nine Months ended September 30,	
	2012	2011	2012	2011
Basic weighted average shares	60,896,042	64,140,926	61,671,214	65,499,763
Effect of dilutive securities:				
Employee and director stock options	553,717	878,992	638,064	1,055,906
Restricted stock	17,091		5,697	
RSU s	5,502		1,834	
Warrants		907,876		1,171,735
Potential dilutive common shares	61,472,352	65,927,794	62,316,809	67,727,404

During the three and nine month periods ended September 30, 2012, weighted average shares of 5,947,939 and 5,536,358 respectively, related to stock options were excluded from the calculation of diluted earnings per share because the option exercise prices exceeded the market price of

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ZixCorp's common stock on that date, and the options were therefore anti-dilutive. During the three and nine month periods ended September 30, 2011, weighted average shares of 4,831,146 and 4,341,573 respectively, related to anti-dilutive stock options were excluded from the calculation of diluted earnings per share. During each of those periods, 145,853 of shares related to anti-dilutive warrants were excluded from that calculation.

7. Commitments and contingencies

A summary of our fixed contractual obligations and commitments at September 30, 2012, is as follows:

	Payments Due by Period				
	Total	1 Year	Years 2 & 3	Years 4 & 5	Beyond 5 Years
Operating leases	\$ 3,123,000	\$ 1,385,000	\$ 1,413,000	\$ 325,000	

We have not entered into any material, non-cancelable purchase commitments at September 30, 2012.

Claims and Proceedings

We are subject to legal proceedings, claims, and litigation against our business. While the outcome of these matters is currently not determinable and the costs and expenses of prosecuting and defending these matters may be significant, we currently do not expect the ultimate costs to resolve these matters will have a material adverse effect on our consolidated financial statements.

8. Fair Value Measurements

FASB guidance regarding fair value measurement establishes a three-tier fair value hierarchy, which prioritizes the inputs used in measuring fair value. These tiers include: Level 1, defined as observable inputs such as quoted prices in active markets for identical assets or liabilities; Level 2, defined as inputs other than quoted prices for similar assets and liabilities in active markets that are either directly or indirectly observable; and Level 3, defined as unobservable inputs for which little or no market data exists, therefore requiring an entity to develop its own assumptions.

For certain of the Company's financial instruments, including cash and cash equivalents, trade receivables, and accounts payable, the fair values approximate carrying values due to the short-term maturities of these instruments. The carrying values of other current assets and accrued expenses are also not recorded at fair value, but approximate fair values primarily due to their short-term nature.

9. Common Stock Repurchase Program

On November 9, 2011, the Company announced that its board of directors approved a share repurchase program authorizing the Company to purchase up to \$15,000,000 of its shares of common stock from time to time in the open market. The Company completed the share repurchase program during the three months ended June 30, 2012, by repurchasing 1,395,658 shares valued at approximately \$4,002,000. The Company repurchased 1,685,308 shares at an aggregate cost of \$4,998,000 under the program during the three months ended March 31, 2012, and repurchased 2,184,353 shares at an aggregate cost of \$6,000,000 under this program during the three months ended December 31, 2011.

10. Income Taxes

At the end of 2011, the Company recorded a \$15,000,000 tax benefit by reducing the valuation allowance related to its deferred tax assets. This reduction was determined through an assessment of future deferred tax asset utilization following accounting guidance which relies largely on historical earnings. Using the same methodology, and updating the future taxable earnings estimates based on 2012 earnings for the first nine months of 2012, the Company believes its future taxable earnings estimate to be established at the end of 2012 will exceed the estimate used at the end of 2011. For this reason, the Company offset its first, second, and third quarter 2012 deferred tax provision by reducing its valuation allowance by an equal amount; thereby eliminating from its deferred tax provision federal taxes in excess of the estimated Alternative Minimum Tax from the Company's first, second, and third quarter 2012 financial statements. The Company will reevaluate the need for its valuation allowance at December 31, 2012, following the same assessment that was performed at December 31, 2011. A substantial portion of the state deferred tax valuation allowance was reduced, and a tax benefit recognized, in the assessment performed at December 31, 2011. As a result, state deferred taxes were provided for in the nine month period ended September 30, 2012.

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

NOTE ON FORWARD-LOOKING STATEMENTS AND RISK FACTORS

Statements in this report which are not purely historical facts or which necessarily depend upon future events, including statements about trends, uncertainties, hopes, beliefs, anticipations, expectations, plans, intentions or strategies for the future, may be forward-looking statements within the meaning of Section 21E of the Securities Exchange Act of 1934. Forward-looking statements involve risks and uncertainties that could cause actual events or results to differ materially from the events or results described in the forward-looking statements, including risks and uncertainties described in our Annual Report on Form 10-K for the fiscal year ended December 31, 2011. Any of these risk factors could have a material adverse effect on our business, financial condition or financial results and reduce the value of an investment in our securities. We may not succeed in addressing these and other risks associated with an investment in our securities, with our business and with our achieving any forward-looking statements. Readers are cautioned not to place undue reliance on forward-looking statements. All forward-looking statements are based upon information available to us on the date the statements are made. We undertake no obligation to publicly update or revise any forward-looking statements, whether as a result of new information, future events or otherwise.

Overview

We are a leader in providing secure, Internet-based applications in a Software as a Service (SaaS) model. ZixCorp's Email Encryption Service enables the use of secure email for sensitive information exchange primarily in the healthcare, financial services, insurance and government sectors. More than 1,500 hospitals and over 1,800 financial institutions, including some of the most influential companies and government organizations, use our Email Encryption Service. Wellpoint and the Securities and Exchange Commission (SEC) are among these notable customers. Our Email Encryption Service is enhanced by ZixDirectory®, which includes approximately 33 million members. ZixDirectory allows for emails to be sent seamlessly whenever possible, across the largest email encryption community in the world.

The business operations and service offerings are supported by the ZixData Center , a network operations center dedicated to secure electronic transaction processing. The operations of the ZixData Center are independently audited annually to maintain AICPA SysTrustSM certification in the areas of security, confidentiality, integrity and availability. Auditors also produce a SOC2 report on the effectiveness of operational controls used over the audit period. The center is staffed 24 hours a day with a proven 99.99% reliability. We enable email communications to be sent in a trusted, safe, and secure manner. This is our core competency and we believe it is a competitive advantage.

Critical Accounting Policies and Estimates

The preparation of financial statements and related disclosures in accordance with accounting principles generally accepted in the United States requires the Company's management to make estimates and assumptions that affect the amounts reported in the Company's condensed consolidated financial statements and accompanying notes. Actual results could differ from these estimates and assumptions. Critical accounting policies and estimates are defined as those that are both most important to the portrayal of the Company's financial condition and results and require management's most subjective judgments.

We describe our significant accounting policies in Note 2, *Summary of Significant Accounting Policies*, of the Notes to Consolidated Financial Statements included in our Annual Report on Form 10-K for the year ended December 31, 2011. We discuss our *Critical Accounting Policies and Estimates* in Management's Discussion and Analysis of Financial Condition and Results of Operations in our Annual Report on Form 10-K for the year ended December 31, 2011.

Results of Operations

Third Quarter 2012 Summary of Operations

Financial

Revenue for the quarter ended September 30, 2012, was \$11,023,000 compared with \$9,558,000 for the same period in 2011 representing a 15% increase.

Gross margin for the quarter ended September 30, 2012, was \$9,136,000 or 83% of revenues compared with \$7,769,000 or 81% of revenues for the comparable period in 2011.

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Net income for the quarter ended September 30, 2012, was \$1,943,000 compared with net income of \$2,571,000 for the same period in 2011.

Ending cash and cash equivalents were \$23,031,000 on September 30, 2012, compared with \$20,680,000 on December 31, 2011.

Operations

New first year orders (NFYOs) for the quarter ended September 30, 2012, were \$2,586,000. As of September 30, 2012, backlog was \$57,010,000.

Revenues

Email Encryption is a subscription-based service. The following table sets forth a period-over-period comparison of the Company's revenues:

	Three Months Ended September 30,		3-month Variance		Nine Months Ended September 30,		9-month Variance	
	2012	2011	2012 vs. 2011	%	2012	2011	2012 vs. 2011	%
Revenues	\$ 11,023,000	\$ 9,558,000	\$ 1,465,000	15%	\$ 31,667,000	\$ 28,260,000	\$ 3,407,000	12%

The increase in Email Encryption revenue was due to the growth inherent in a successful subscription model with steady additions to the subscriber base coupled with a high rate of existing customer renewals.

Revenue Indicators Backlog and Orders

Backlog Our end-user order backlog is comprised of contractually bound agreements that we expect to amortize into revenue as the services are performed. The timing of revenue is affected by both the length of time required to deploy a service and the length of the service contract.

As of September 30, 2012, total backlog was \$57,010,000 and we expect approximately 57% of the total backlog to be recognized as revenue during the next twelve months. The backlog as of September 30, 2012, was comprised of the following elements: \$19,882,000 of deferred revenue that has been billed and paid, \$5,325,000 billed but unpaid, and approximately \$31,803,000 of unbilled contracts.

Orders Total orders were \$12,660,000 and \$9,687,000 for the three month periods ended September 30, 2012 and 2011, respectively. Total orders include contract renewals, NFYOs, and in the case of new multi-year contracts, the years beyond the first year of service. NFYOs were \$2,586,000 and \$1,641,000 for the three months ended September 30, 2012 and 2011, respectively.

Cost of Revenues

The following table sets forth a period-over-period comparison of the cost of revenues:

	Three Months Ended September 30,		3-month Variance		Nine Months Ended September 30,		9-month Variance	
	2012	2011	2012 vs. 2011	%	2012	2011	2012 vs. 2011	%
Cost of revenues	\$ 1,887,000	\$ 1,789,000	\$ 98,000	5%	\$ 5,554,000	\$ 5,362,000	\$ 192,000	4%

Cost of revenues is comprised of costs related to operating and maintaining the ZixData Center, a field deployment team, customer service and support and the amortization of Company-owned, customer-based computer appliances. A significant portion of the total cost of revenues relates to the ZixData Center, which currently has excess capacity. The five percent increase in the third quarter of 2012 compared to the same quarter last year as well as the four percent increase for the year to date comparative periods, resulted primarily from increases in average wages and benefits for existing staff plus minor increases in software maintenance and software license expenses.

Research and Development Expenses

The following table sets forth a period-over-period comparison of our research and development expenses:

	Three Months Ended September 30,		3-month Variance		Nine Months Ended September 30,		9-month Variance	
	2012	2011	2012 vs. 2011	%	2012	2011	2012 vs. 2011	%
Research and Development	\$ 2,046,000	\$ 1,343,000	\$ 703,000					