

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, 1998

or

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 333-35563

VASCO Data Security International, Inc.  
(Exact Name of Registrant as Specified in Its Charter)

DELAWARE 36-4169320  
(State or Other Jurisdiction of (I.R.S. Employer  
Incorporation or Organization) Identification No.)

1901 South Meyers Road, Suite 210  
Oakbrook Terrace, Illinois 60181  
(Address of Principal Executive Offices)(Zip Code)

Registrant's telephone number, including area code: (630) 932-8844

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

As of November 13, 1998, 20,805,697 shares of the Company's Common Stock, \$.001 par value per share ("Common Stock"), were outstanding.

VASCO Data Security International, Inc.  
Form 10-Q  
For The Three and Nine Months Ended September 30, 1998

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This report contains the following trademarks of the Company, some of which are registered: VASCO and Digipass.

## PART I. FINANCIAL INFORMATION

## Item 1. Consolidated Financial Statements

VASCO Data Security International, Inc.  
Consolidated Balance Sheets

	December 31, 1997	September 30, 1998 (Unaudited)
ASSETS		
Current assets:		
Cash	\$1,897,666	\$1,101,020
Accounts receivable, net of allowance for doubtful accounts of \$429,000 and \$61,000 in 1997 and 1998	2,458,451	3,280,516
Inventories, net	1,001,294	1,729,883
Prepaid expenses	86,426	654,328
Deferred income taxes	83,000	83,000
Other current assets	221,572	153,683
	-----	-----
Total current assets	5,748,409	7,002,430
Property and equipment		
Furniture and fixtures	488,338	580,598
Office equipment	322,434	426,075
	-----	-----
	810,772	1,006,673
Accumulated depreciation	(497,381)	(633,174)
	-----	-----
	313,391	373,499
Goodwill, net of accumulated amortization of \$198,000 and \$295,000 in 1997 and 1998		
	704,124	607,439
Other assets	1,609,901	1,103,236
	-----	-----
Total assets	\$8,375,825	\$9,086,604
	=====	=====

LIABILITIES AND STOCKHOLDERS'

EQUITY (DEFICIT)

Current liabilities:

Current maturities of long-term debt	\$3,185,400	\$5,682,437
Accounts payable	1,083,965	868,695
Customer deposits	426,914	482,376
Other accrued expenses	1,606,810	1,944,453
	-----	-----
Total current liabilities	6,303,089	8,977,961

Long-term debt, including stockholder note of \$5,000,000 in 1997 and 1998	8,442,946	8,491,746
--	-----------	-----------

Common stock subject to redemption	494,668	-
------------------------------------	---------	---

Stockholders' equity (deficit):

Common stock, \$.001 par value - 75,000,000 shares authorized; 20,132,968 shares issued and outstanding in 1997; 20,336,057 shares issued and outstanding in 1998	20,133	20,336
Additional paid-in capital	9,186,726	9,797,538
Accumulated deficit	(15,901,575)	(18,221,555)
Accumulated other comprehensive income-cummulative translation adjustment	(170,162)	20,578
	-----	-----

Total stockholders' equity (deficit)	(6,864,878)	(8,383,103)
	-----	-----

Total liabilities and stockholders' equity (deficit)	\$8,375,825	\$9,086,604
	=====	=====

See accompanying notes to consolidated financial statements.

VASCO Data Security International, Inc.  
Consolidated Statements of Operations  
(Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	1997	1998	1997	1998
	----	----	----	----
Net revenues	\$2,844,975	\$4,025,326	\$ 9,436,669	\$10,431,673
	-----	-----	-----	-----
Total revenues	2,844,975	4,025,326	9,436,669	10,431,673
Cost of goods sold	1,468,297	1,877,796	4,759,003	5,023,831
	-----	-----	-----	-----
Gross profit	1,376,678	2,147,530	4,677,666	5,407,842
	-----	-----	-----	-----
Operating costs:				
Sales and marketing	885,026	1,117,710	2,802,515	3,046,850
Research and development	668,691	420,815	986,620	1,248,781
General and administrative	1,393,369	765,939	3,100,641	1,759,879
	-----	-----	-----	-----
Total operating costs	2,947,086	2,304,464	6,889,776	6,055,510
	-----	-----	-----	-----
Operating loss	(1,570,408)	(156,934)	(2,212,110)	(647,668)
Interest expense	(105,741)	(223,341)	(566,176)	(1,102,926)
Other income (expense), net	57,949	(88,480)	(14,502)	(189,636)
	-----	-----	-----	-----
Loss before income taxes	(1,618,200)	(468,755)	(2,792,788)	(1,940,230)
Provision for income taxes	463,127	248,407	520,299	379,750
	-----	-----	-----	-----
Net loss	(2,081,327)	(717,162)	(3,313,087)	(2,319,980)
Preferred stock dividends	(26,000)	-	(80,000)	-
	-----	-----	-----	-----
Net loss available to common stockholders	\$(2,107,327)	\$ (717,162)	\$(3,393,087)	\$(2,319,980)
	=====	=====	=====	=====
Basic and diluted loss per common share	\$ (0.11)	\$ (0.04)	\$ (0.18)	\$ (0.11)
	=====	=====	=====	=====
Shares used to compute basic and diluted loss per common share	19,279,620	20,331,057	18,753,213	20,352,197
	=====	=====	=====	=====

See accompanying notes to consolidated financial statements.

VASCO Data Security International, Inc.  
 Consolidated Statements of Comprehensive Income  
 (Unaudited)

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	1997	1998	1997	1998
	----	----	----	----
Net loss	\$(2,081,327)	\$(717,162)	\$(3,313,087)	\$(2,319,980)
Other comprehensive income - Cum. Transl. Adj.	(70,845)	85,788	(157,315)	190,740
	-----	-----	-----	-----
Comprehensive loss	\$(2,152,172)	\$(631,374)	\$(3,470,402)	\$(2,129,240)
	=====	=====	=====	=====

See accompanying notes to consolidated financial statements.

VASCO Data Security International, Inc.  
Consolidated Statements of Cash Flows  
(Unaudited)

	Nine Months Ended September 30, 1997 -----	1998 -----
Cash flows from operating activities:		
Net loss	\$ (3,313,087)	\$ (2,319,980)
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Depreciation and amortization	810,221	743,770
Interest paid in shares of common stock	193,196	-
Loss on disposition of fixed assets	-	5,113
Changes in current assets and current liabilities:		
Accounts receivable, net	1,226,255	(822,065)
Inventories, net	1,087,333	(728,590)
Prepays and other current assets	244,004	(500,013)
Accounts payable	(1,239,005)	(215,270)
Customer deposits	(407,941)	55,462
Other accrued expenses	577,181	337,643
	-----	-----
Net cash used in operating activities	(821,843)	(3,443,930)
	-----	-----
Cash flows from investing activities - additions to PP&E	(97,392)	(205,640)
	-----	-----
Net cash used in investing activities	(97,392)	(205,640)
	-----	-----
Cash flows from financing activities:		
Series B preferred stock dividends	(80,000)	-
Net proceeds (payments) related to sales of common stock	(56,895)	115,347
Proceeds from exercise of stock options	42,470	1,000
Redemption of common stock	(247,261)	-
Proceeds from issuance of debt	2,716,141	2,545,837
Repayment of debt	(51,263)	-
	-----	-----
Net cash provided by financing activities	2,323,192	2,662,184
Effect of exchange rate changes on cash	(157,315)	190,740
	-----	-----
Net increase (decrease) in cash	1,246,642	(796,646)
Cash, beginning of period	1,813,593	1,897,666
	-----	-----
Cash, end of period	\$ 3,060,235	\$ 1,101,020
	=====	=====

Supplemental disclosure of  
cash flow information:

Interest paid	\$	222,720	\$	693,668
Income taxes paid		-		227,852

See accompanying notes to consolidated financial statements.

VASCO Data Security International, Inc.  
Notes to Consolidated Financial Statements

Note 1 - Basis of Presentation

The accompanying unaudited consolidated financial statements include the accounts of VASCO Data Security International, Inc. and its subsidiaries (collectively, the "Company") and have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission regarding interim financial reporting. Accordingly, they do not include all of the information and notes required by generally accepted accounting principles for complete financial statements and should be read in conjunction with the audited consolidated financial statements included in the Company's Annual Report on Form 10-K for the year ended December 31, 1997.

In the opinion of management, the accompanying unaudited consolidated financial statements have been prepared on the same basis as the audited consolidated financial statements, and include all adjustments, consisting only of normal recurring adjustments, necessary for the fair presentation of the results of the interim periods presented. The operating results for the interim periods presented are not necessarily indicative of the results expected for a full year.

Note 2 - Exchange Offer

VASCO Data Security International, Inc. ("VDSI Inc.") was organized in 1997 as a subsidiary of VASCO Corp., a Delaware corporation ("VASCO Corp."). Pursuant to an exchange offer ("Exchange Offer") by VDSI Inc. for securities of VASCO Corp. that was completed March 11, 1998, VDSI Inc. acquired 97.7% of the outstanding common stock of VASCO Corp. Consequently, VASCO Corp. became a subsidiary of VDSI Inc., with certain VASCO Corp. shareholders holding the remaining 2.3% of the VASCO Corp. common stock representing a minority interest. The impact of the minority interest is not material to the Company's consolidated financial statements. The December 31, 1997 financial statements have been restated to account for the Exchange Offer as a transaction between entities under common control in a manner similar to a pooling of interests.

The assets and liabilities of VASCO Corp. were recorded by VDSI Inc. at their historical carrying values.

Subsequent to September 30, 1998, the Company completed the exchange of the remaining 2.3%.



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

The Company designs, develops, markets and supports open standards-based hardware and software security systems which manage and secure access to data.

The following discussion is based upon the Company's consolidated results of operations for the three and nine months ended September 30, 1998 as compared to VASCO Corp.'s consolidated results of operations for the three and nine months ended September 30, 1997. See "Note 2 - Exchange Offer."

Cautionary Statement for Purposes of the "Safe Harbor" Provisions of the Private Securities Litigation Reform Act of 1995

This Quarterly Report on Form 10-Q, including the "Management's Discussion and Analysis of Financial Condition and Results of Operations," contains "forward-looking statements" within the meaning of the Private Securities Litigation Reform Act of 1995 concerning, among other things, the prospects, developments and business strategies for the Company and its operations, including the development and marketing of certain new products and the anticipated future growth in certain markets in which the Company currently markets and sells its products or anticipates selling and marketing its products in the future. These forward-looking statements (i) are identified by their use of such terms and phrases as "expected," "expects," "believe," "believes," "will," "anticipated," "emerging," "intends," "plans," "could," "may," "estimates," "should," "objective," and "goals" and (ii) are subject to risks and uncertainties and represent the Company's present expectations or beliefs concerning future events. The Company cautions that the forward-looking statements are qualified by important factors that could cause actual results to differ materially from those in the forward-looking statements, including (a) risks of general market conditions, including demand for the Company's products and services, competition and price levels and the Company's historical dependence on relatively few products, certain suppliers and certain key customers, and (b) risks inherent to the computer and network security industry, including rapidly changing technology, evolving industry standards, increasing numbers of patent infringement claims, changes in customer requirements, price competitive bidding, changing government regulations and potential competition from more established firms and others. Therefore, results actually achieved may differ materially from expected results included in, or implied by these statements.

Comparison of Three and Nine Months Ended September 30, 1997 and September 30, 1998

The following discussion and analysis should be read in conjunction with the Company's Consolidated Financial Statements for the three and nine months ended September 30, 1997 and 1998.

#### Revenues

Revenues for the three months ended September 30, 1998 were \$4,025,000, an increase of \$1,180,000, or 41%, as compared to the three months ended September 30, 1997. This increase can be attributed to increased demand related to the Company's newest product, Digipass 300, as well as follow-on orders received from current customers.

For the nine months ended September 30, 1998, revenues increased 11% to \$10,432,000 from \$9,437,000 in 1997. This increase is due to a strong performance from international operations, as the demand for Digipass 300 continues to grow. In addition, favorable currency exchange rates benefited the Company.

#### Cost of Goods Sold

Cost of goods sold for the three months ended September 30, 1998 was \$1,878,000, an increase of \$409,000, or 28%, as compared to the three months ended September 30, 1997. This increase is consistent with the increase in revenues for the same period.

For the nine months ended September 30, 1998, cost of goods sold increased 6% to \$5,024,000 from \$4,759,000 in 1997. This increase is consistent with the increase in revenues for the same period. The cost of goods sold for security products, however, decreased as a percentage of revenues at a quicker pace than revenues for security products due to efficiencies in the design of the products which resulted in reduced third-party manufacturing costs.

#### Gross Profit

The Company's gross profit for the three months ended September 30, 1998 was \$2,148,000, an increase of \$771,000, or 56%, as compared to the three months ended September 30, 1997. This represents a gross margin of 53% as compared to 48% for the same period in 1997. The increase reflects increased shipments to the Company's direct customers during the third quarter of 1998, which results in a slightly higher margin, as well as efficiencies in the design of the products which resulted in reduced third-party manufacturing costs.

For the nine months ended September 30, 1998, gross profit was \$5,408,000, an increase of \$730,000, or 16%, as compared to 1997. This represents a gross margin of 52% as compared to 50% for the same period in 1997. Margins have remained relatively steady during 1998. With the introduction of the Digipass 300 in 1998, the Company anticipates improved gross margins as acceptance of the Digipass 300 increases.

## Sales and Marketing Expenses

Sales and marketing expenses for the three months ended September 30, 1998 were \$1,118,000, an increase of \$233,000, or 26%, over the three months ended September 30, 1997. Selling and marketing expenses also increased 9% in the first nine months of 1998 to \$3,047,000 from \$2,803,000 in the first nine months of 1997. The increases are attributed to increased sales efforts including, in part, increased travel costs and an increase in marketing activities, including the development of a company-wide marketing program and other efforts.

## Research and Development

Research and development costs for the three months ended September 30, 1998 were \$421,000, a decrease of \$248,000, or 37%, as compared to the three months ended September 30, 1997. Research and development costs increased 27% in the first nine months of 1998 to \$1,249,000 from \$987,000 in the first nine months of 1997. This increase is due to the addition of R&D personnel, in both the U.S. and Europe.

## General and Administrative Expenses

General and administrative expenses for the three months ended September 30, 1998 were \$766,000, a decrease of \$627,000, or 45%, compared to the three months ended September 30, 1997. General and administrative expenses decreased 43% in the first nine months of 1998 to \$1,760,000 from \$3,101,000 in the first nine months of 1997. The decreases were due to economies of scale being realized as a result of the combination of the operations of Lintel Security and VASCO Data Security during 1997, as well as a favorable experience with regard to bad debt recovery and a reduction of certain legal fees associated with the Exchange Offer. In addition, the Company was preparing for the Exchange Offer during 1997, thus generating significant legal and accounting expenses.

## Interest Expense

Interest expense for the three months ended September 30, 1998 was \$223,000, compared to \$106,000, an increase of 111% over the same period of 1997. Interest expense increased 95% in the first nine months of 1998 to \$1,103,000 from \$566,000 in the first nine months of 1997. The increases can be attributed to an increased borrowing base during 1998, partially offset by the reversal of contingent interest payable that was not realized.

## Operating Income (Loss)

The Company's operating loss for the three months ended September 30, 1998 was \$157,000, compared to \$1,570,000 for the three months ended September 30, 1997. The Company had an operating loss of \$648,000 for the first nine months of 1998, as compared to \$2,212,000 for the first nine months of 1997, a decrease of 71%.

## Income Taxes

Income tax expense for the three months ended September 30, 1998 were \$248,000, compared to \$463,000 for the three months ended September 30, 1997. For the nine months ended September 30, 1998, income tax expense totaled \$380,000, compared to expense of \$520,000 for the same period in 1997. All of these taxes are attributable to the Company's European operations.

## Liquidity and Capital Resources

Since inception, the Company has financed its operations through a combination of the issuance of equity securities, private borrowings, short-term commercial borrowings, cash flow from operations, and loans from Mr. T. Kendall Hunt, its Chief Executive Officer and one of the stockholders of the Company's original corporate predecessor.

The Company's cash and cash equivalents were \$1,101,000 at September 30, 1998, which is a decrease of approximately \$797,000 from \$1,898,000 at December 31, 1997. As of September 30, 1998, the Company had negative working capital of \$1,976,000.

Capital expenditures during the first nine months of 1998 were \$206,000 and consisted primarily of computer equipment and office furniture and fixtures.

The Company intends to seek acquisitions of businesses, products and technologies that are complementary or additive to those of the Company. While from time to time the Company engages in discussions with respect to potential acquisitions, the Company has no present plans, commitments or agreements with respect to any such acquisitions as of the date of this Form 10-Q and currently does not have excess cash for use in making acquisitions. There can be no assurance that any such acquisitions will or will not be made.

The Company believes that its current cash balances and anticipated cash generated from operations will be sufficient to meet its anticipated cash needs through March 1999. Continuance of the Company's operations beyond March 1999, however, will depend on the Company's ability to obtain adequate financing. In March 1998, the Company entered into a loan agreement in the amount of \$3 million with Lernout & Hauspie Speech Products N.V. ("L&H"); the funding of this occurred in April 1998. The loan bears interest at the prime rate plus 1%, payable quarterly, and matures on January 4, 1999.

The Company has previously entered into engagement letters with Artesia Bank and KBC Securities for a possible future private offering and a possible future public offering. Further, the Company has had preliminary discussions regarding other possible debt or equity financing. There can be no assurance, however, that the Company will be successful in effecting a private or public offering or obtaining other additional financing.

In October 1998, the Company entered into a financing arrangement with KBC Bank for a \$2.9 million revolving line of credit, which was drawn upon to repay the Generale Bank notes that were outstanding at September 30, 1998. The line of credit automatically renews every three months and is due and payable upon the successful completion of a private placement or public offering of the Company's securities.

#### Year 2000 Considerations

Many existing computer systems and software products are coded to accept only two digits entries in the date code field with respect to year. With the 21st century less than two years away, the date code field must be adjusted to allow for a four digit year. The Company believes that its internal systems are Year 2000 compliant, but the Company will need to take the required steps to make its existing products compliant. The total estimated cost of this exercise is \$150,000, with an anticipated completion date of December 31, 1998. To date, the Company has spent approximately \$110,000 in connection with its Year 2000 compliance efforts. There can be no assurance, however, that the Company will meet its anticipated completion date or that the total cost will not exceed \$150,000. The Company believes that the purchasing patterns of customers and potential customers may be affected by Year 2000 issues as companies expend significant resources to upgrade their current software systems for Year 2000 compliance. This, in turn, could result in reduced funds available to be spent on other technology applications, such as those offered by the Company, which could have a material adverse effect on the Company's business and results of operations.

#### PART II. OTHER INFORMATION

##### Item 1. Legal Proceedings

On November 2, 1998, the Company was served with a lawsuit filed against it by Security Dynamics Technologies, Inc. alleging patent infringement. The Company believes that it is protected by its patents and that this lawsuit is without merit.

Item 2. Changes in Securities. None.

Item 3. Defaults upon Senior Securities. None.

Item 4. Submission of Matters to a Vote of Securityholders. None.

Item 5. Other Information

Discretionary Proxy Voting Authority/Stockholder Proposals

On May 21, 1998, the Securities and Exchange Commission adopted an amendment to Rule 14a-4, as promulgated under the Securities Exchange Act of 1934. The amendment to Rule 14a-4(c)(1) governs the Company's use of its discretionary proxy voting authority with respect to a stockholder proposal which the stockholder has not sought to include in the Company's proxy statement. The new amendment provides that, if a proponent of a proposal fails to notify the Company at least 45 days prior to the month and day of mailing of the prior year's proxy statement, then the management proxies will be allowed to use their discretionary voting authority when the proposal is raised at the meeting, without any discussion of the matter in the proxy statement.

With respect to the Company's 1999 Annual Meeting of Stockholders, if the Company is not provided notice of a stockholder proposal, which the stockholder has not previously sought to include in the Company's proxy statement by April 3, 1999, the management proxies will be allowed to use their discretionary authority as outlined above.

Item 6. Exhibits and Reports on Form 8-K

a) The following exhibits are filed with this Form 10-Q or incorporated by reference as set forth below:

Exhibit

Number Description

27 Financial Data Schedule.

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(b) Reports on Form 8-K

No reports on Form 8-K have been filed by the Registrant during the quarter ended September 30, 1998.

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) 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, on November 13, 1998.

VASCO Data Security International, Inc.

/s/ T. Kendall Hunt

T. Kendall Hunt  
Chairman of the Board, Chief Executive  
Officer and President

/s/ Gregory T. Apple

Gregory T. Apple  
Vice President and Treasurer  
(Principal Financial Officer and  
Principal Accounting Officer)

EXHIBIT INDEX

Exhibit Number	Description
27	Financial Data Schedule.

9-MOS  
 DEC-31-1998  
 SEP-30-1998  
 1,101,020  
 0  
 3,341,516  
 61,000  
 1,729,883  
 7,002,430  
 1,006,673  
 633,174  
 9,086,604  
 8,977,961  
 0  
 0  
 20,336  
 (8,403,439)  
 9,086,604  
 10,431,673  
 10,431,673  
 5,023,831  
 6,055,510  
 189,636  
 0  
 1,102,926  
 (1,940,230)  
 379,750  
 (2,319,980)  
 0  
 0  
 0  
 (2,319,980)  
 (0.11)  
 (0.11)