

INTELLIGENT SYSTEMS CORP

Form 10QSB

August 11, 2006

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UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-QSB

(Mark One)

☒ **QUARTERLY REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the quarterly period ended June 30, 2006

OR

☐ **TRANSITION REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the transition period from _____ to _____

Commission file number 1-9330

INTELLIGENT SYSTEMS CORPORATION

(Exact name of Registrant as specified in its charter)

Georgia

58-1964787

(State or other jurisdiction of incorporation or organization)

(I.R.S. Employer Identification No.)

4355 Shackleford Road, Norcross, Georgia

30093

(Address of principal executive offices)

(Zip Code)

Issuer's telephone number, including area code: **(770) 381-2900**

Indicate by a check mark whether the issuer (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the past 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 is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes ☐ No ☒

As of July 31, 2006, 4,478,971 shares of Common Stock were outstanding.

Transitional Small Business Disclosure Format (check one): Yes ☐ No ☒

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Intelligent Systems Corporation
CONSOLIDATED BALANCE SHEETS

(in thousands, except share amounts)

	June 30, 2006 <i>(unaudited)</i>	December 31, 2005
ASSETS		
Current assets:		
Cash	\$ 447	\$ 378
Accounts receivable, net	3,590	1,827
Inventories	1,039	770
Other current assets	498	355
Total current assets	5,574	3,330
Long-term investments	4,173	4,571
Property and equipment, at cost less accumulated depreciation	1,150	940
Goodwill, net	2,047	2,047
Other intangibles, net	445	532
Other assets, net	28	17
Total assets	\$ 13,417	\$ 11,437
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Short-term borrowings	\$ 2,012	\$ 100
Accounts payable	1,801	847
Deferred revenue	4,531	4,779
Accrued payroll	1,036	1,092
Accrued expenses and other current liabilities	1,263	849
Total current liabilities	10,643	7,667
Other long-term liabilities	486	248
Commitments and contingencies (Note 8)		
Minority interest	1,516	1,516
Stockholders' equity:		
Common stock, \$0.01 par value, 20,000,000 shares authorized, 4,478,971 shares issued and outstanding at June 30, 2006 and December 31, 2005	45	45
Paid-in capital	18,410	18,410

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Accumulated other comprehensive loss	(74)	(61)
Accumulated deficit	(17,609)	(16,388)
Total stockholders' equity	772	2,006
Total liabilities and stockholders' equity	\$ 13,417	\$ 11,437

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

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Intelligent Systems Corporation
CONSOLIDATED STATEMENTS OF OPERATIONS
(unaudited; in thousands, except share and per share amounts)

	Three Months Ended June		Six Months Ended June 30	
	2006	2005	2006	2005
Revenue				
Products	\$ 2,427	\$ 2,820	\$ 4,466	\$ 4,883
Services	1,802	1,842	5,374	3,358
Total revenue	4,229	4,662	9,840	8,241
Cost of sales				
Products	1,226	869	2,227	1,732
Services	751	980	2,404	1,849
Total cost of sales	1,977	1,849	4,631	3,581
Expenses				
Marketing	595	601	1,186	1,142
General & administrative	949	800	2,143	1,759
Research & development	1,545	1,675	3,245	3,302
Loss from operations	(837)	(263)	(1,365)	(1,543)
Other income				
Interest income (expense), net	(33)	12	(61)	18
Investment income, net	2	914	7	1,956
Equity in earnings of affiliate companies	91	19	163	36
Other income, net	1	13	35	21
Income (loss) before income taxes	(776)	695	(1,221)	488
Income taxes				12
Net income (loss)	\$ (776)	\$ 695	\$ (1,221)	\$ 476
Basic net income (loss) per share	\$ (0.17)	\$ 0.16	\$ (0.27)	\$ 0.11
Diluted net income (loss) per share	\$ (0.17)	\$ 0.15	\$ (0.27)	\$ 0.10
Basic weighted average shares outstanding	4,478,971	4,478,971	4,478,971	4,478,971
Diluted weighted average shares outstanding	4,478,971	4,628,183	4,478,971	4,638,043

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

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Intelligent Systems Corporation
CONSOLIDATED STATEMENTS OF CASH FLOW
(unaudited, in thousands)

	Six Months Ended June 30,	
CASH PROVIDED BY (USED FOR):	2006	2005
OPERATIONS:		
Net income (loss)	\$ (1,221)	\$ 476
Adjustments to reconcile net income (loss) to net cash provided by (used for) operating activities:		
Depreciation and amortization	260	257
Stock based compensation expense	6	
Investment income, net	(7)	(1,956)
Equity in earnings of affiliate companies	(163)	(36)
Changes in operating assets and liabilities		
Accounts receivable	(1,763)	(661)
Inventories	(269)	(88)
Other current assets	(143)	(269)
Other non-current assets		8
Accounts payable	953	(32)
Accrued payroll	(56)	284
Deferred revenue	(248)	898
Accrued expenses and other current liabilities	398	(37)
Other liabilities	239	
Cash used for operating activities	(2,014)	(1,156)
INVESTING ACTIVITIES:		
Proceeds related to sales of investments	183	2,117
Purchases of intangible assets		(6)
Distributions from long-term investments	385	9
Purchases of property and equipment	(384)	(268)
Cash provided by investing activities	184	1,852
FINANCING ACTIVITIES:		
Borrowings under short-term borrowing arrangements	1,912	705
Repayments under short-term borrowing arrangements		(672)
Cash provided by financing activities	1,912	33
Effects of exchange rate changes on cash	(13)	32
Net increase in cash	69	761

Cash at beginning of period	378	670
Cash at end of period	\$ 447	\$ 1,431

SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:

Cash paid during the period for interest	\$ 41	\$ 7
Cash paid during the period for income taxes		

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

Table of Contents**Intelligent Systems Corporation****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

1. Throughout this report, the terms we, us, ours, ISC and company refer to Intelligent Systems Corporation, including its majority-owned subsidiaries.
2. The unaudited consolidated financial statements presented in this Form 10-QSB have been prepared in accordance with accounting principles generally accepted in the United States applicable to interim financial statements. Accordingly, they do not include all of the information and notes required for complete financial statements. In the opinion of ISC management, these consolidated financial statements contain all adjustments (which comprise only normal and recurring accruals) necessary to present fairly the financial position and results of operations as of and for the three and six month periods ended June 30, 2006 and 2005. The interim results for the three and six months ended June 30, 2006 are not necessarily indicative of the results to be expected for the full year. These statements should be read in conjunction with our consolidated financial statements and notes thereto for the fiscal year ended December 31, 2005, as filed in our annual report on Form 10-KSB.
3. Comprehensive Income (Loss) In accordance with Financial Accounting Standards Board Statement No. 130, Reporting Comprehensive Income, comprehensive income (loss) is the total of net income (loss) and all other non-owner changes in equity in a period. A summary follows:

Consolidated Statements of Comprehensive Income (loss) (unaudited, in thousands)	Three Months Ended June 30,		Six Months Ended June 30,	
	2006	2005	2006	2005
Net income (loss)	\$ (776)	\$ 695	\$ (1,221)	\$ 476
Other comprehensive income (loss):				
Foreign currency translation adjustment	(15)	17	(13)	32
Unrealized loss on available-for-sale securities		24		(85)
Comprehensive income (loss)	\$ (791)	\$ 736	\$ (1,234)	\$ 423

4. Stock-Based Compensation At June 30, 2006, we had two stock-based compensation plans under which stock options have been granted. Stock options for employees generally vest over a three or four year term and stock options for directors vest over a two year term; options have a maturity of ten years from issuance date; and option exercise prices are equal to the closing price on the American Stock Exchange of the common stock on the grant date. Prior to 2006, we accounted for stock-based compensation in accordance with the Accounting Principles Board (APB) No. 25, Accounting for Stock Issued to Employees, which permitted companies to use the alternative intrinsic value method of accounting for stock based compensation and we adopted the disclosure provisions of SFAS No. 123, Accounting for Stock Issued to Employees. In December 2005, the FASB issued FASB Statement No. 123R, Share Based Payment, which replaced APB No. 25 and SFAS No. 123. The change was effective for our company for the reporting period beginning January 1, 2006. SFAS No. 123R requires companies to recognize in financial statements the cost of employee services received in exchange for awards of equity instruments based on the grant-date fair value of those awards. We have adopted SFAS 123R using the modified prospective application method of adoption which requires the company to record compensation cost related to unvested stock awards as of December 31, 2005 by recognizing the unamortized grant date fair value in accordance with provisions of SFAS 123R on a straight line basis over the service periods of each award. The company has estimated forfeiture rates based on its historical experience. Stock based compensation for the three and six month periods ended June 30, 2006 has been recognized as a component of general and administrative expenses in the accompanying Consolidated Financial Statements.

No options were granted, exercised or forfeited in the first six months of 2006. In the second quarter of 2005, 12,000 options were granted at fair market value on the date of grant pursuant to the Non-employee Directors Stock Option Plan. The estimated fair value of the options granted during prior years was calculated using the Black Scholes option pricing model with assumptions as previously disclosed.

As a result of adopting SFAS 123R, the impact to the Consolidated Financial Statements was to increase the net loss for the three and six months ended June 30, 2006 by \$3,000 and \$6,000, respectively, than if the company had continued to account for stock-based compensation under APB 25. The impact on both basic and diluted loss per share for the three and six months ended June 30, 2006 was \$0 and \$0 per share, respectively. Pro forma net loss as if the fair value based method had been applied to all awards is as follows:

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<i>(in thousands, except per share data)</i>	Three Months Ended June 30,		Six Months Ended June 30,	
	2006	2005	2006	2005
Net income (loss), reported	\$ (776)	\$ 695	\$ (1,221)	\$ 476
Add: stock-based compensation programs recorded as expense, net of related tax	3		6	
Deduct: total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax	(3)	(10)	(6)	(18)
Pro forma net income (loss)	\$ (776)	\$ 685	\$ (1,221)	\$ 458
Income (loss) per common share:				
Basic, as reported	\$ (0.17)	\$ 0.16	\$ (0.27)	\$ 0.11
Basic, pro forma	\$ (0.17)	\$ 0.15	\$ (0.27)	\$ 0.10
Diluted, as reported	\$ (0.17)	\$ 0.15	\$ (0.27)	\$ 0.10
Diluted, pro forma	\$ (0.17)	\$ 0.15	\$ (0.27)	\$ 0.10

All of the company's stock-based compensation expense relates to stock options. As of June 30, 2006, \$6,000 of total unrecognized compensation cost related to stock options is expected to be recognized over a weighted average period of approximately 1 year. No options were granted, exercised or forfeited during the three or six month period ended June 30, 2006. The following table summarizes options as of June 30, 2006:

	# of Shares	Wgt Avg Exercise Price	Wgt Avg Remaining Life in Years	Aggregate Intrinsic Value
Outstanding at June 30, 2006	238,680	\$2.56	5.7	\$55,440
Vested and exercisable at June 30, 2006	232,680	2.57	5.4	55,440

The aggregate intrinsic value in the table above represents the total pre-tax intrinsic value (the difference between the company's closing stock price on the last trading day of the second quarter of 2006 and the exercise price, multiplied by the number of in-the-money options) that would have been received by the option holders had all option holders exercised their options on June 30, 2006. The amount of aggregate intrinsic value will change based on the fair market value of the company's stock.

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5. *Industry Segments* Segment information is presented consistently with the basis described in the 2005 Form 10-KSB. The table following contains segment information for the three and six month periods ended June 30, 2006 and 2005.

<i>(unaudited, in thousands)</i>	Three Months Ended June		Six Months Ended June 30,	
	2006	30, 2005	2006	2005
<i>Information Technology</i>				
Revenue	\$ 2,101	\$ 3,219	\$ 5,987	\$ 5,095
Operating loss	(641)	(192)	(674)	(1,501)
<i>Industrial Products</i>				
Revenue	2,128	1,443	3,853	3,146
Operating income (loss)	78	153	(16)	442
<i>Consolidated Segments</i>				
Revenue	\$ 4,229	\$ 4,662	\$ 9,840	\$ 8,241
Operating loss	(563)	(39)	(689)	(1,059)

A reconciliation of consolidated segment data above to consolidated income (loss) follows:

Consolidated segments operating loss	\$ (563)	\$ (39)	\$ (689)	\$ (1,059)
Corporate expenses	(274)	(224)	(676)	(484)
Consolidated operating loss	(837)	(263)	(1,365)	(1,543)
Interest income (expense), net	(33)	12	(61)	18
Investment income	2	914	7	1,956
Equity in income of affiliates	91	19	163	36
Other income, net	1	13	35	21
Income (loss) before income taxes	(776)	695	(1,221)	488
Income taxes				12
Net income (loss)	\$ (776)	\$ 695	\$ (1,221)	\$ 476
<i>Depreciation and Amortization</i>				
Information Technology	\$ 69	\$ 69	\$ 139	\$ 133
Industrial Products	65	62	125	117
Consolidated segments	134	131	264	250
Corporate	(7)	1	(3)	7
Consolidated depreciation and amortization	\$ 127	\$ 132	\$ 261	\$ 257

Capital Expenditures

Information Technology	\$ 14	\$ 44	\$ 22	\$ 57
Industrial Products	140	173	338	181
Consolidated segments	154	217	360	238
Corporate	6	30	24	30
Consolidated capital expenditures	\$ 160	\$ 247	\$ 384	\$ 268

	June 30, 2006 (unaudited)	December 31, 2005
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Identifiable Assets

Information Technology	\$ 4,893	\$ 3,746
Industrial Products	3,967	2,913
Consolidated segments	8,860	6,659
Corporate	4,557	4,778
Consolidated assets	\$ 13,417	\$ 11,437

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6. *Concentration of Revenue* The following table indicates the percentage of consolidated revenue represented by each customer for any period in which such customer represented more than 10% of consolidated revenue.

(unaudited)	Three Months Ended June 30,		Six Months Ended June 30,	
	2006	2005	2006	2005
VISAer Customer A			18%	
VISAer Customer B		14%		
VISAer Customer C	11%			10%

7. *Contract Settlement* In March 2006, our VISAer subsidiary reached a mutual agreement with one of its customers to terminate a Software License Agreement between them. The Settlement and Release Agreement assigns no fault to either party and provides for a refund to the customer of \$512,000 of certain prepaid maintenance and other expenses, with such refund to be paid interest-free in monthly installments of \$14,222 over a three year period. Accordingly, since VISAer had completed all of the requirements for revenue recognition, in the quarter ended March 31, 2006, VISAer recognized \$1,779,000 in services revenue and \$827,174 in cost of sales related to this contract, and recorded the refund amount as a liability of which \$135,000 was recorded in other current liabilities and \$311,000 in long-term liabilities at March 31, 2006, (\$446,000 in total, which is equal to \$512,000 discounted at 9.25%). At June 30, 2006, the amount related to this settlement that is included in current and long-term liabilities is \$135,077 and \$277,924, respectively. The liability, which is an obligation of VISAer, is not secured by any assets or guaranteed by the parent company.
8. *Commitments and Contingencies* Please refer to Note 8 to our Consolidated Financial Statements included in our 2005 Form 10-KSB for a description of our commitments and contingencies. There has been no material change since December 31, 2005 in the commitments described in such note, except that the Contract Settlement referenced in Note 7 above involves a commitment by our VISAer subsidiary to make monthly payments of \$14,222 each beginning April 1, 2006 until the \$512,000 refund due its customer is paid in full.

Legal Matters In December 2004, ChemFree filed a patent infringement action against J. Walter Co. Ltd. and J. Walter, Inc. in the United States Court for the Northern District of Georgia. The complaint alleges that certain of the defendant's products infringe various U.S. patents held by ChemFree and seeks a ruling to compel defendant to cease its infringing activities. The defendant has asserted various defenses and a counterclaim. The case is pending and no trial date has been set. In 2005, ChemFree participated in an arbitration proceeding versus ZYMO International, Inc. (Zymo), a patent co-owner, that resulted in the issuance of a favorable arbitration ruling for ChemFree. In December 2005, ChemFree initiated a proceeding under the Federal Arbitration Act in the United States District Court for the Northern District of Georgia to obtain judicial confirmation of the arbitration ruling and to arbitrate a number of other disputes between ChemFree and Zymo that fall within the arbitration provisions of the co-ownership agreement between the parties. In July 2006, the judge issued a ruling confirming ChemFree's request to compel arbitration and the matter will now move through the arbitration process. While the resolution and timing of any legal action is not predictable, ChemFree believes it has sufficient grounds to prevail in these actions although there can be no assurance that the disputes will be resolved in its favor.

ISC Guarantees In conjunction with a Software License Agreement entered into on June 12, 2003 between our majority owned subsidiary, CoreCard Software, Inc. and a CoreCard customer, ISC entered into a letter of guarantee with the CoreCard customer. Under the guarantee, in the event that the Software License is terminated due to CoreCard discontinuing operations, ISC has guaranteed to make available at its expense up to four employees to provide technical assistance to the customer during a transition period of up to one year. The guarantee is limited to the amount paid by the customer to CoreCard under the Software License Agreement at the

time of termination. The guarantee phases out upon the achievement of certain operational milestones by CoreCard or after five years, whichever occurs sooner. As of June 30, 2006, it does not appear probable that the guarantee will be paid; thus no amounts have been accrued with respect to this guarantee.

In connection with and to facilitate a software license contract between Ardext Technologies, Inc., a privately held company in which ISC holds a minority ownership, and a customer of Ardext's, ISC entered into agreements with Ardext and the customer to receive and hold milestone payments by the customer and to return such payments either to the customer or to Ardext depending on the outcome of Ardext's performance under the contract. At June 30, 2006, ISC has recorded payments totaling \$150,000 received from the customer as Other Current Liabilities on the balance sheet and ISC expects to return such amount to the customer in August 2006 based on a recent

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decision by the customer to terminate the Ardext Technologies project. ISC has no other obligations under the agreements.

9. *Significant Equity Investee* The following condensed financial information is provided for Horizon Software, LLC, an investee company in which we own a 17% equity interest and which, at June 30, 2006, constituted more than 20% of our consolidated assets.

(unaudited, in thousands)	Three Months Ended June 30,		Six Months Ended June 30,	
	2006	2005	2006	2005
Net sales	\$ 5,272	\$ 4,956	\$ 9,609	\$ 8,554
Gross profit	3,826	3,781	7,084	6,544
Net income from continuing operations	556	924	912	1,047
Net income	556	924	912	1,047
ISC share of net income	95	158	156	179

10. *New Accounting Pronouncements* In December 2005, the FASB issued FASB Statement No. 123R, Share Based Payment, which replaces APB No. 25 and SFAS No. 123. The change is effective for small business issuers for the first interim or annual reporting period that begins after December 15, 2005. SFAS No. 123R requires companies to recognize in financial statements the cost of employee services received in exchange for awards of equity instruments based on the grant-date fair value of those awards. We adopted SFAS No. 123R effective January 1, 2006. There was no material impact on our results of operations or financial condition. Refer to Note 4.

In December 2004, the FASB issued FASB Statement No. 151, Inventory Costs. An amendment of ARB No. 43. SFAS No. 151 clarifies that certain abnormal amounts of production related expenses should be expensed as incurred and not included in overhead. Further, it requires that allocation of fixed production overheads to conversion costs should be based on normal capacity of production facilities. FASB No. 151 is effective for fiscal years beginning after June 15, 2005. We adopted SFAS No. 151 effective January 1, 2006. The adoption of this standard did not have a material impact on our financial position and results of operations.

11. *Subsequent Event* Effective July 31, 2006, the company completed the sale of the business and certain assets of its QS Technologies, Inc. (QS) subsidiary to Netsmart Public Health, Inc. and its parent company, Netsmart Technologies, Inc. [NASDAQ SC:NTST]. The company sold assets associated with the QS business consisting principally of intangibles, furniture and equipment, prepaid expenses and work-in-process for a combination of \$1.9 million in cash