INTELLISYNC CORP
Form 10-Q
December 12, 2005

FORM 10-Q

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

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

For the quarterly period ended October 31, 2005

OR

o 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 0-21709

INTELLISYNC CORPORATION

(Exact name of Registrant as specified in its charter)

Delaware	**77-0349154**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification Number)

2550 North First Street, San Jose, California 95131

(Address of principal executive office and zip code)

(408) 321-7650

(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 ý No o

Indicate by check mark whether the Registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act).

Yes ý No o

Indicate by check mark whether the Registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes o No ý

Indicate the number of shares outstanding of each of the issuer s classes of common stock, as of December 8, 2005: **67,557,940**

INTELLISYNC CORPORATION

10-Q REPORT

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INTELLISYNC CORPORATION

PART I - FINANCIAL INFORMATION

Item 1. **Unaudited Condensed Consolidated Financial Statements**

CONDENSED CONSOLIDATED BALANCE SHEETS

(In thousands, except per share data)

(Unaudited)

	October 31, 2005	July 31, 2005
Assets		
Current assets:		
Cash and cash equivalents	$ 19,246	$ 19,533
Short-term investments	16,448	19,319
Accounts receivable, net of allowance for doubtful accounts of $402 and $564	14,122	13,682
Inventories	41	46
Other current assets	2,632	3,190
Total current assets	52,489	55,770
Property and equipment, net	3,517	3,028
Goodwill	68,494	68,474
Other intangible assets, net	23,647	25,946
Restricted cash	4,891	4,306
Other assets	3,099	3,269
Total assets	$ 156,137	$ 160,793
Liabilities and Stockholders Equity		
Current liabilities:		
Accounts payable	$ 2,295	$ 2,584
Accrued liabilities	7,411	7,569
Current portion of obligations under capital lease	154	153
Deferred revenue	7,608	7,396
Total current liabilities	17,468	17,702
Obligations under capital lease	173	206
Long term deferred revenue	614	228
Convertible senior notes	56,963	57,531
Other liabilities	3,457	2,915
Total liabilities	78,675	78,582

Commitments and contingencies (Note 7)				
Stockholders equity:				
Preferred stock, $0.001 par value; 2,000 shares authorized; none issued and outstanding at October 31, 2005 and July 31, 2005				
Common stock, $0.001 par value; 160,000 shares authorized; 67,281 and 66,639 shares issued and outstanding at October 31, 2005 and July 31, 2005		67		67
Additional paid-in capital		230,280		227,014
Accumulated deficit		(152,544)		(144,530)
Accumulated other comprehensive loss		(341)		(340)
Total stockholders equity		77,462		82,211
Total liabilities and stockholders equity	$	156,137	$	160,793

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

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INTELLISYNC CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(In thousands, except per share data)

(Unaudited)

	Three Months Ended October 31, 2005	Three Months Ended October 31, 2004
Revenue		
License	$ 10,265	$ 7,825
Services	6,080	4,477
Total revenue	16,345	12,302
Cost and operating expenses:		
Cost of revenue	3,073	2,341
Amortization of developed and core technology	1,257	1,156
Research and development	4,981	3,329
Sales and marketing	8,583	5,589
General and administrative	4,201	2,049
Amortization of other intangibles	1,048	1,046
Restructuring and merger charges	606	
Total cost and operating expenses	23,749	15,510
Operating loss	(7,404)	(3,208)
Other expense, net:		
Interest income	310	236
Interest expense	(563)	(240)
Other, net	(250)	(179)
Total other expense, net	(503)	(183)
	(7,907)	(3,391)
Provision for income taxes	(107)	(115)
Net loss	$ (8,014)	$ (3,506)
Basic and diluted net loss per common share	$ (0.12)	$ (0.05)
Shares used in computing basic and diluted net loss per common share	66,981	64,418

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

INTELLISYNC CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)

(Unaudited)

	Three Months Ended October 31, 2005	Three Months Ended October 31, 2004
Cash flows from operating activities:		
Net loss	$ (8,014)	$ (3,506)
Adjustments to reconcile net loss to net cash used in operating activities:		
Allowance for doubtful accounts	(162)	61
Depreciation	391	278
Amortization of other intangibles	2,305	2,202
Amortization of debt issuance costs	164	159
Non-cash stock compensation expense (reversal)	2,231	(65)
Changes in operating assets and liabilities:		
Accounts receivable	(278)	(540)
Inventories	5	16
Other current assets	644	831
Accounts payable	(289)	891
Accrued liabilities	(184)	(1,179)
Deferred revenue	598	(246)
Net cash used in operating activities	(2,589)	(1,098)
Cash flows from investing activities:		
Purchase of property and equipment	(880)	(755)
Purchase of short term investments	(192)	(1,028)
Proceeds from the sales of short-term investments	2,280	500
Proceeds from the maturities of short-term investments	800	1,000
(Increase) decrease in restricted cash	(685)	416
Net cash provided by investing activities	1,323	133
Cash flows from financing activities:		
Debt issuance costs		(89)
Principal payments on capital leases	(32)	(24)
Proceeds upon exercise of stock options	681	161
Proceeds from ESPP shares issued	354	300
Net cash provided by financing activities	1,003	348
Effect of exchange rate changes on cash and cash equivalents	(24)	105
Net decrease in cash and cash equivalents	(287)	(512)
Cash and cash equivalents at beginning of period	19,533	12,991
Cash and cash equivalents at end of period	$ 19,246	$ 12,479

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

INTELLISYNC CORPORATION

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Note 1 The Company and a Summary of its Significant Accounting Policies

The Company

Intellisync Corporation (Intellisync or the Company) develops, markets and supports desktop, enterprise and mobile carrier-class software that enables consumers, business executives and information technology professionals to extend the capabilities of enterprise groupware and vertical applications, data-enabled mobile devices and other personal communication platforms. The primary software applications the Company has developed and marketed include push-email, data synchronization and systems management software. The Company s software also enables organizations to search, find, match and synchronize identity data within their computer systems and network databases.

On November 15, 2005, the Company entered into a merger agreement with Nokia Inc., a Delaware corporation. Refer to Note 13 Subsequent Events for more details.

Liquidity and Capital Resources

The Company has incurred losses and negative cash flows since inception. The Company incurred a net loss of approximately $8,014,000 and negative cash flows from operations of approximately $2,589,000 for the three months ended October 31, 2005. The Company s cash balances may decline further, although the Company believes that the effects of its strategic actions implemented to improve revenue as well as control costs along with existing cash resources will be adequate to fund its operations for at least the next 12 months. Failure to generate sufficient revenues or control spending could adversely affect the Company s ability to achieve its business objectives.

Basis of Presentation and Consolidation

The accompanying condensed consolidated financial statements of Intellisync as of October 31, 2005 and for the three months ended October 31, 2005 are unaudited and reflect all normal recurring adjustments which are, in the opinion of management, necessary for the fair statement of such financial statements. These condensed consolidated financial statements should be read in conjunction with the Company s consolidated financial statements and notes thereto included in the Company s Annual Report on Form 10-K for the fiscal year ended July 31, 2005. The condensed consolidated balance sheet as of July 31, 2005 has been derived from the audited financial statements at that date but does not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. The results of operations for the interim period ended October 31, 2005 are not necessarily indicative of results to be expected for the full year.

The accompanying condensed consolidated financial statements include the accounts of the Company and its wholly owned subsidiaries. All significant inter-company balances and transactions have been eliminated in consolidation.

Use of Estimates and Assumptions

The preparation of the consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires the Company to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the condensed consolidated financial statements and the reported amounts of revenue and expenses during the reporting period. On an on-going basis, the Company evaluates its estimates, including those related to provision for doubtful accounts, channel inventory and product returns, valuation of goodwill and intangibles, investments and other long-lived assets, restructuring accruals, valuation of income taxes, license and services revenue recognition, contingencies and stock-based compensation. The Company bases its estimates on various factors and information which may include, but are not limited to, history and prior experience, experience of other enterprises in the same industry, new related events, current economic conditions and information from third party professionals that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions.

Revenue Recognition

Revenue is derived from software licenses and related services, which include implementation and integration of software solutions, post contract support, training, hosting and consulting.

Transactions involving the sale of software products are accounted for under the American Institute of Certified Public Accountants (AICPA) Statement of Position (SOP) No. 97-2, *Software Revenue Recognition*, as amended by SOP No. 98-9, *Modification of 97-2, Software Revenue Recognition with Respect to Certain Transactions*. For contracts with multiple elements, and for which vendor-specific objective evidence of fair value for the undelivered elements exists, revenue is recognized for the delivered elements based upon the residual contract value as prescribed by SOP No. 98-9. The Company has accumulated relevant information from contracts to use in determining the availability of vendor-specific objective evidence and believes that such information complies with the criteria established in SOP No. 97-2 as follows:

Customers are required to pay separately for maintenance. Optional stated future renewal rates are included as a term of the contracts. The Company uses the renewal rate as vendor-specific objective evidence of fair value for maintenance.

The Company charges standard hourly rates for consulting services, when such services are sold separately, based upon the nature of the services and experience of the professionals performing the services.

For training, the Company charges standard rates for each course based upon the duration of the course, and such courses are separately priced in contracts. The Company has a history of selling such courses separately.

Revenue from license fees is recognized when persuasive evidence of an arrangement exists, delivery of the product has occurred, no significant Company obligations with regard to implementation or integration exist, the fee is fixed or determinable and collectibility is probable. Arrangements for which the fees are not deemed probable for collection are recognized upon cash collection. Payments from customers received in advance of revenue recognition are recorded as deferred revenue.

Service revenue primarily comprises revenue from consulting fees, maintenance contracts, training and hosting fees. Service revenue from consulting, hosting and training is recognized as the service is performed. Maintenance contracts include the right to unspecified upgrades and ongoing support. Maintenance revenue is deferred and recognized ratably as services are provided over the maintenance period.

License and service revenue on contracts involving significant implementation, customization or services, that are essential to the functionality of the software is recognized over the period of each engagement, primarily using the percentage-of-completion method. Costs incurred are generally used as the measure of progress towards completion as prescribed by SOP No. 81-1, *Accounting for Performance of Construction-Type and Certain Product-Type Contracts*. Revenue for these arrangements is classified as license revenue and service revenue based upon estimates of fair value for each element, and the revenue is recognized based on the percentage-of-completion ratio for the arrangement. A provision for estimated losses on engagements is made in the period in which the loss becomes probable and can be reasonably estimated. The Company considers a project completed when all contractual obligations have been met (generally the go live date).

The Company currently licenses its products directly to individuals, small businesses and corporations, to original equipment manufacturers, or OEMs, and to distributors and value-added resellers in North America, Europe, the Asia-Pacific region, South America and Africa. Revenue from products distributed indirectly through major distributors and resellers is recognized on a sell through basis. Agreements with the Company s major distributors and resellers contain specific product return privileges for stock rotation and obsolete products that are generally limited to contractual amounts. Reserves for estimated future returns are provided for upon revenue recognition. Product returns are recorded as a reduction of revenue. Accordingly, the Company has established a product returns reserve composed of 100% of product inventories held at the Company s distribution partners, as well as an estimated amount for returns from customers of the distributors and other resellers as a result of stock rotation and obsolete products. Such reserves are based on:

historical product returns and inventory levels on a product by product basis;

current inventory levels and sell through data on a product by product basis as reported by the Company s major distributors worldwide;

demand forecast by product in each of the principal geographic markets, which is impacted by the Company s product release schedule, seasonal trends and analyses developed by the Company s internal sales and marketing group; and

general economic conditions.

The Company licenses rights to use its technology portfolio, whereby licensees, particularly OEMs, typically pay a non-refundable license fee in one or more installments and on-going royalties based on their sales of products incorporating the Company s technology. Revenue from OEMs under minimum guaranteed royalty arrangements, which are not subject to future obligations, is recognized when such royalties are earned and become payable. Royalty revenue is recognized as earned when reasonable estimates of such amounts can be made. Royalty revenue that is subject to future obligations is recognized when such obligations are fulfilled. Royalty revenue that exceeds minimum guarantees is recognized in the period earned.

Stock-Based Compensation Expense

On August 1, 2005, the Company adopted Statement of Financial Accounting Standards (SFAS) No. 123 (revised 2004) or 123(R), *Share-Based Payment*, which requires the measurement and recognition of compensation expense for all share-based payment awards made to employees and directors including employee stock options and employee stock purchases related to the Employee Stock Purchase Plan (employee stock purchases) based on estimated fair values. SFAS No. 123(R) supersedes the Company s previous accounting under Accounting Principles Board (APB) Opinion No. 25, *Accounting for Stock Issued to Employees* for periods beginning in fiscal 2006. In March 2005, the Securities and Exchange Commission issued Staff Accounting Bulletin (SAB) No. 107 relating to SFAS No. 123(R). The Company has applied the provisions of SAB No. 107 in its adoption of SFAS No. 123(R).

The Company adopted SFAS No. 123(R) using the modified prospective transition method, which requires the application of the accounting standard as of August 1, 2005, the first day of the Company s fiscal year 2006. The Company s condensed consolidated financial statements as of and for the three months ended October 31, 2005 reflect the impact of SFAS No. 123(R). In accordance with the modified prospective transition method, the Company s condensed consolidated financial statements for prior periods have not been restated to reflect, and do not include, the impact of SFAS No. 123(R). Stock-based compensation expense recognized under SFAS No. 123(R) for the three months ended October 31, 2005 was $2,231,000 which consisted of stock-based compensation expense related to employee stock options and employee stock purchases. Stock-based compensation reversal of $65,000 for the three months ended October 31, 2004 was related to employee stock options subject to variable accounting which the Company had been recognizing under previous accounting standards. Refer to Note 8 for additional information.

SFAS No. 123(R) requires companies to estimate the fair value of share-based payment awards on the date of grant using an option-pricing model. The value of the portion of the award that is ultimately expected to vest is recognized as expense over the requisite service periods in the Company s consolidated statement of operations. Prior to the adoption of SFAS No. 123(R), the Company accounted for stock-based awards to employees and directors using the intrinsic value method in accordance with APB Opinion No. 25 as allowed under SFAS No. 123, *Accounting for Stock-Based Compensation*. Under the intrinsic value method, no stock-based compensation expense had been recognized in the Company s consolidated statement of operations, other than as related to stock options accounted for using variable accounting, because the exercise price of the Company s stock options granted to employees and directors equaled the fair market value of the underlying stock at the date of grant.

Stock-based compensation expense recognized during the period is based on the value of the portion of share-based payment awards that is ultimately expected to vest during the period. Stock-based compensation expense recognized in the Company s consolidated statement of operations for the first quarter of fiscal 2006 included compensation expense for share-based payment awards granted prior to, but not yet vested as of July 31, 2005 based on the grant date fair value estimated in accordance with the pro forma provisions of SFAS No. 123 and compensation expense for the share-based payment awards granted subsequent to July 31, 2005 based on the grant date fair value estimated in accordance with the provisions of SFAS No. 123(R). Compensation expense for all share-based payment awards are recognized using the accelerated multiple-option approach. As stock-based compensation expense recognized in the consolidated statement of operations for the first quarter of fiscal 2006 is based on awards ultimately expected to vest, it has been reduced for estimated forfeitures. SFAS No. 123(R) requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. In the Company s pro forma information required under SFAS No. 123 for the periods prior to fiscal 2006, the Company accounted for forfeitures as they occurred.

Upon adoption of SFAS No. 123 (R), the Company continued to use the Black-Scholes option-pricing model as its method of valuation for share-based awards. For additional information, refer to Note 8. The Company s determination of fair value of share-based payment awards on the date of grant using an option-pricing model is affected by the Company s stock price as well as assumptions regarding a number of highly complex and subjective variables. These variables include, but are not limited to the Company s expected stock price volatility over the term of the awards, and actual and projected employee stock option exercise behaviors. Option-pricing models were developed for use in estimating the value of traded options that have no vesting or hedging restrictions and are fully transferable. Because the Company s employee stock options have certain characteristics that are significantly different from traded options, and because changes in the subjective assumptions can materially affect the estimated value, in management s opinion, the existing valuation models may not provide an accurate measure of the fair value of the Company s employee stock options. Although the fair value of employee stock options is determined in accordance with SFAS No. 123(R) and SAB No. 107 using an option-pricing model, that value may not be indicative of the fair value observed in a willing buyer/willing seller market transaction.

Note 2 Recently Issued Accounting Pronouncements

Share-Based Payment

In September 2005, the Financial Accounting Standards Board (FASB) issued FASB Staff Position (FSP) No. FAS 123(R)-1, *Classification and Measurement of Freestanding Financial Instruments Originally Issued in Exchange for Employee Services under FASB Statement No. 123(R)*, to defer the requirement of SFAS No. 123(R) that a freestanding financial instrument originally subject to SFAS No. 123(R) becomes subject to the recognition and measurement requirements of other applicable GAAP when the rights conveyed by the instrument to the holder are no longer dependent on the holder being an employee of the entity. The rights under stock-based payment awards the Company issued to its employees are all dependent on the recipient being an employee of Intellisync. Therefore, this FSP currently does not have an impact on the Company s consolidated financial statements and its measurement of stock-based compensation in accordance with SFAS No. 123(R).

In October 2005, the FASB issued FSP No. FAS 123(R)-2, *Practical Accommodation to the Application of Grant Date as Defined in FASB Statement No. 123(R)*, to provide guidance on determining the grant date for an award as defined in SFAS No. 123(R). This FSP stipulates that assuming all other criteria in the grant date definition are met, a mutual understanding of the key terms and conditions of an award to an individual employee is presumed to exist upon the award s approval in accordance with the relevant corporate governance requirements, provided that the key terms and conditions of an award (a) cannot be negotiated by the recipient with the employer because the award is a unilateral grant, and (b) are expected to be communicated to an individual recipient within a relatively short time period from the date of approval. The Company has applied the principles set forth in this FSP upon its adoption of SFAS No. 123(R).

Accounting for Conditional Asset Retirement Obligations, an interpretation of FASB Statement No. 143

In March 2005, the FASB issued Interpretation (FIN) No. 47, *Accounting for Conditional Asset Retirement Obligations, an interpretation of FASB Statement No. 143, Accounting for Asset Retirement Obligations.* FIN No. 47 clarifies when an entity would be required to recognize a liability for the fair value of an asset retirement obligation that is conditional on a future event if the liability s fair value can be reasonably estimated. Uncertainty surrounding the timing and method of settlement that may be conditional on events occurring in the future would be factored into the measurement of the liability rather than the recognition of the liability. FIN No. 47 is effective no later than the end of fiscal years ending after December 15, 2005. The Company does not expect the adoption of this statement will have a material impact on its financial statements.

Accounting Changes and Error Corrections

In June 2005, the FASB issued SFAS No. 154, *Accounting Changes and Error Corrections*, which replaces APB Opinion No. 20, *Accounting Changes*, and SFAS No. 3, *Reporting Accounting Changes in Interim Financial Statements*. SFAS No. 154 changes the requirements for the accounting and reporting of a change in accounting principle. APB Opinion No. 20 previously required that most voluntary changes in an accounting principle be recognized by including the cumulative effect of the new accounting principle in net income of the period of the change. SFAS No. 154 now requires retrospective application of changes in an accounting principle to prior period financial statements, unless it is impracticable to determine either the period-specific effects or the cumulative effect of the change. The Statement is effective for fiscal years beginning after December 15, 2005. The Company does not expect the adoption of this statement on August 1, 2006 will have a material impact on its financial statements.

Other-Than-Temporary Impairment

In June 2005, the FASB decided not to provide additional guidance on the meaning of other-than-temporary impairment, and directed the staff to issue proposed FSP EITF 03-1-a, *Implementation Guidance for the Application of Paragraph 16 of EITF Issue No. 03-1*, as final. The final FSP will supersede EITF Issue No. 03-1, *The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments*, and EITF Topic No. D-44, *Recognition of Other-Than-Temporary Impairment upon the Planned Sale of a Security Whose Cost Exceeds Fair Value*. The final FSP (retitled FSP FAS No. 115-1, *The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments*) will replace the guidance set forth in paragraphs 10-18 of EITF No. 03-1 with references to existing other-than-temporary impairment guidance, such as SFAS No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, SEC SAB No. 59, *Accounting for Noncurrent Marketable Equity Securities*, and APB Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock.* FSP FAS No. 115-1 will codify the guidance set forth in EITF Topic D-44 and clarify that an investor should recognize an impairment loss no later than when the impairment is deemed other than temporary, even if a decision to sell has not been made. FSP FAS No. 115-1 will be effective for other-than-temporary impairment analysis conducted in periods beginning after September 15, 2005. The Company does not believe the adoption of FSP FAS No. 115-1 will have a significant impact on its consolidated results of operations or financial position.

Amortization Period for Leasehold Improvements

In June 2005, the EITF reached a consensus on Issue No. 05-06, *Determining the Amortization Period for Leasehold Improvements.* The guidance requires that leasehold improvements acquired in a business combination or purchased subsequent to the inception of a lease be amortized over the lesser of the useful life of the assets or a term that includes renewals that are reasonably assured at the date of the business combination or purchase. The guidance is effective for periods beginning after June 29, 2005. The adoption of this guidance did not and is not expected to have an impact on the Company s financial position, results of operations or cash flows.

Rental Costs Incurred during a Construction Period

On October 6, 2005, the FASB issued FSP No. 13-1, *Accounting for Rental Costs Incurred during a Construction Period*. FSP No. 13-1 requires that rental costs associated with ground or building operating leases that are incurred during a construction period be recognized as rental expense. FSP No. 13-1 is effective for the first reporting period after December 15, 2005. The Company has historically expensed rental costs incurred during a construction period; therefore, the adoption of this guidance will not have an impact on its net earnings, cash flows or financial position.

Note 3 Balance Sheets Components

Inventories consist of the following (in thousands):

	October 31, 2005	July 31, 2005
Raw materials	$ 35	$ 11
Finished goods and work-in-process	6	35
Inventories	$ 41	$ 46

Note 4 Acquisitions

During fiscal 2005, the Company acquired PDAapps, Inc. and Tourmaline Networks, Inc. The PDAapps, and Tourmaline transactions were accounted for as business combinations pursuant to SFAS No. 141, *Business Combinations*.

PDAapps, Inc.

On June 23, 2005, the Company completed its acquisition of all of the issued and outstanding stock of PDAapps, Inc., makers of Intellisync IM (formerly VeriChat), the mobile instant messaging solution for all Palm OS devices, Pocket PC devices, Symbian devices and RIM Blackberry devices. Under the terms of an Agreement and Plan of Merger, dated as of June 23, 2005, the outstanding shares of PDAapps common stock were converted into the right to receive (i) an aggregate of approximately $4,000,000 in aggregate initial cash consideration and (ii) an aggregate of up to $2,600,000 in cash earnout consideration (based on future revenue generated by the Company from the former PDAapps client base), subject to the deposit of $1,000,000 in escrow to be available to compensate Intellisync pursuant to the indemnification obligations of the holders of PDAapps common stock. The earnout consideration, if achieved, is due and payable shortly following the first anniversary of the acquisition. As of October 31, 2005, the Company has not accrued the contingent earnout payment amount. Any earnout consideration paid will be recorded as additional goodwill.

The condensed consolidated financial statements include the results of operations of PDAapps since the date of acquisition. Under the purchase method of accounting, the total purchase price was allocated to PDAapps net tangible and intangible assets based upon their estimated fair value as of the acquisition date. The initial purchase price of $4,150,000 (including estimated acquisition costs of $150,000) was assigned to the fair value of the assets acquired, including the following (in thousands):

Tangible assets acquired	$	74
Deferred tax assets		976
Liabilities assumed		(337)
Deferred tax liability assumed		(976)
In-process research and development		220
Developed and core technology		2,320
Customer base		140
Covenant-not-to-compete		24
Goodwill		1,709
	$	4,150

In accordance with SFAS No. 109, *Accounting for Income Taxes*, deferred tax liabilities of approximately $976,000 have been recorded for the tax effect of the amortizable intangible assets. Deferred tax assets of $976,000 have also been recorded by the Company to account for the tax effect of the Company s net operating loss and credit carryforwards.

Tangible assets acquired, which includes $46,000 of cash, and liabilities assumed were valued at their respective carrying amounts as the Company believes that these amounts approximated their current fair values at the acquisition date. The valuation of identifiable intangible assets acquired was based on management s estimates, currently available information and reasonable and supportable assumptions. This allocation was generally based on the fair value of these assets determined using the income approach.

An estimate of $1,709,000 has been allocated to goodwill. Goodwill represents the excess of the purchase price over the fair value of the net tangible and intangible assets acquired. In accordance with SFAS No. 142, *Goodwill and Other Intangible Assets*, goodwill is not amortized but is tested for impairment at least annually.

Of the total purchase price, $2,484,000 was allocated to amortizable intangibles included in the above list. The developed and core technology and customer base are being amortized in proportion with the expected cash flows to be received from the underlying assets over their estimated useful life of five and seven years, respectively. The covenant-not-to-compete is being amortized using the straight-line method over the estimated useful life of the asset of 30 months.

As of the acquisition date, technological feasibility of the in-process technology had not been established and the technology had no alternative future use. Accordingly, the Company expensed the in-process research and development at the date of the acquisition.

The amount of the purchase price allocated to in-process research and development was based on established valuation techniques used in the high-technology software industry. The fair value assigned to the acquired in-process research and development was determined using the income approach, which discounts expected future cash flows to present value. The key assumptions used in the valuation include, among others, expected completion date of the in-process projects identified as of the acquisition date, estimated costs to complete the projects, revenue contributions and expense projections assuming the resulting product has entered the market, and discount rate based on the risks associated with the development life cycle of the in-process technology acquired. The discount rate used in the present value calculations are normally obtained from a weighted-average cost of capital analysis, adjusted upward to account for the inherent uncertainties surrounding the successful development of the in-process research and development, the expected profitability levels of such technology, and the uncertainty of technological advances that could potentially impact the estimates. The Company assumes the pricing model for the resulting product of the acquired in process research and development to be standard within its industry. The Company, however, did not take into consideration any consequential amount of expense reductions from integrating the acquired in-process technology with other existing in-process or completed technology. Therefore, the valuation assumptions do not include significant anticipated cost savings.

The key assumptions underlying the valuation of acquired in-process research and development from PDAapps are as follows (in thousands, except percentage):

Project names: Enhanced version of VeriChat product - to feature J2ME (Java 2 Platform, Micro Edition) and IMode support, presence manager (uses phone state to dictate the status of a user so others can decide if they should send an instant messaging (IM) or place a call), secure enterprise chat and carrier branded chat

Percent completed as of acquisition date: 30-50%

Estimated costs to complete technology at acquisition date: $900

Risk-adjusted discount rate: 25%

First period expected revenue: 2nd quarter of calendar year 2006

The development of the above technology remains highly dependent on the remaining efforts to achieve technical viability, rapidly changing customer markets, uncertain standards for a new product, and significant competitive threats from several companies. The nature of the efforts to develop this technology into a commercially viable product consists primarily of planning, designing, experimenting, and testing activities necessary to determine that the technology can meet market expectations, including functionality and technical requirements. Failure to bring the product to market in a timely manner could result in a loss of market share or a lost opportunity to capitalize on emerging markets, and could have a material adverse impact on the Company s business and operating results.

Subsequent to the acquisition of PDAapps, there have been no significant developments related to the current status of the acquired in-process research and development project that would result in material changes to the assumptions.

Tourmaline Networks, Inc.

On March 1, 2005, the Company completed its acquisition of all of the issued and outstanding stock of Tourmaline Networks, Inc., a privately held developer and marketer of mobile email based on QUALCOMM s BREW® solution headquartered in San Diego, California. Under the terms of an Agreement and Plan of Merger, dated as of February 9, 2005, the outstanding shares of Tourmaline common stock were converted into the right to receive (i) an aggregate of approximately $4,118,000 in aggregate initial cash consideration and (ii) an aggregate of up to $2,881,918 in cash earnout consideration (based on future revenue generated by the Company from the former Tourmaline client base), subject to the deposit of a certain portion of the initial cash consideration and earnout consideration in escrow to be available to compensate Intellisync pursuant to the indemnification obligations of the holders of Tourmaline common stock. The earnout consideration, if achieved, is due and payable shortly following the first anniversary of the acquisition. As of October 31, 2005, the Company has not accrued the contingent earnout payment amount. Any earnout consideration paid will be recorded as additional goodwill.

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The condensed consolidated financial statements include the results of operations of Tourmaline since the date of acquisition. Under the purchase method of accounting, the total purchase price was allocated to Tourmaline s net tangible and intangible assets based upon their estimated fair value as of the acquisition date. The initial purchase price of $4,218,000 (including estimated acquisition costs of $100,000) was assigned to the fair value of the assets acquired, including the following (in thousands):

Tangible assets acquired	$	478
Deferred tax assets		803
Liabilities assumed		(275)
Deferred tax liability assumed		(803)
Developed and core technology		800
Customer base		1,443
Goodwill		1,772
	$	4,218

In accordance with SFAS No. 109, *Accounting for Income Taxes*, deferred tax liabilities of approximately $803,000 have been recorded for the tax effect of the amortizable intangible assets. Deferred tax assets of $803,000 have also been recorded by the Company to account for the tax effect of the Company s net operating loss and credit carryforwards.

Tangible assets acquired, which includes $23,000 of cash, and liabilities assumed were valued at their respective carrying amounts as the Company believes that these amounts approximated their current fair values at the acquisition date. The valuation of identifiable intangible assets acquired was based on management s estimates, currently available information and reasonable and supportable assumptions. This allocation was generally based on the fair value of these assets determined using the income approach.

An estimate of $1,772,000 has been allocated to goodwill. Goodwill represents the excess of the purchase price over the fair value of the net tangible and intangible assets acquired. In accordance with SFAS No. 142, *Goodwill and Other Intangible Assets*, goodwill will not be amortized but will be tested for impairment at least annually.

Of the total purchase price, $2,243,000 was allocated to amortizable intangibles included in the above list. The amortizable intangible assets are being amortized using an accelerated method according to the expected cash flows to be received from the underlying assets over their respective estimated useful life of three to six years.

Unaudited Pro Forma Consolidated Combined Results

The following unaudited pro-forma consolidated financial information reflects the results of operations for the three months ended October 31, 2004, as if Tourmaline acquisition had occurred on August 1, 2004 and after giving effect to purchase accounting adjustments. The effect of PDAapps acquisition has been excluded from the pro forma financial information as amounts are considered immaterial to the Company. Since the acquisitions took place in fiscal 2005, the results of operations of PDAapps and Tourmaline are included in the Company s condensed consolidated results of operations for the three months ended October 31, 2005.

These pro forma results have been prepared for comparative purposes only and do not purport to be indicative of what operating results would have been had the acquisitions in aggregate actually taken place on August 1, 2004. In addition, these results are not intended to be a projection of future results and do not reflect any synergies that might be achieved from the combined operation (in thousands, except per share data):

		Three Months Ended October 31, 2004
Pro forma revenue	$	12,660
Pro forma net loss	$	(3,576)
Pro forma basic and diluted net loss per common share	$	(0.06)

The effect of the in-process research and development charges has been excluded in the above unaudited pro forma consolidated financial information as they represent non-recurring charges directly related to the acquisitions.

Note 5 Related Party Transactions

On August 29, 2005, the Company entered into a severance agreement and mutual release with its Chief Strategy Officer, Steve Goldberg, in connection with Mr. Goldberg s resignation from employment by the Company effective August 31, 2005. Pursuant to the terms of the agreement, Mr. Goldberg receives, among other items, a lump sum payment of $110,000, twelve months of accelerated vesting of his options to purchase shares of the Company s common stock, the right to exercise his vested options until six months following his termination date and six months of COBRA premiums paid by the Company. The agreement includes a general mutual release by the Company and Mr. Goldberg and a non-solicitation agreement by Mr. Goldberg for twelve months following the effective date of the agreement. The lump sum payment of $110,000 is included in Restructuring and Merger Charges in the accompanying condensed consolidated statement of operations for the three months ended October 31, 2005.

On October 15, 2005, the Company entered into a severance agreement and mutual release with its Chief Technology Officer, Said Mohammadioun, in connection with Mr. Mohammadioun s resignation from employment by the Company effective October 15, 2005. Pursuant to the terms of the agreement, Mr. Mohammadioun received, among other items, a lump sum payment of $46,875, two and a half months of accelerated vesting of his options to purchase shares of the Company s common stock, the right to exercise his vested options until six months following his termination date and two and a half months of COBRA premiums paid by the Company. The agreement includes a general mutual release by the Company and Mr. Mohammadioun and a non-solicitation agreement by Mr. Mohammadioun for twelve months following the effective date of the agreement. The lump sum payment of $46,875 is included in Research and Development in the accompanying condensed consolidated statement of operations for the three months ended October 31, 2005.

As a result of the modification of the stock awards described above in the event that an employee terminates prior to the time that the options would have vested under the original terms, the Company will incur additional compensation expense based on the intrinsic value at the time of the acceleration of vesting, reduced by the amounts previously expensed as a result of the acceleration. The terminations of the officers discussed above and the acceleration of their stock options, therefore, resulted in additional equity-based compensation of approximately $55,000.

Note 6 Long-Term Debt

The following table sets forth the Company s long-term obligations, excluding capital lease obligations (in thousands):

	October 31, 2005	July 31, 2005
3% convertible senior notes, interest due semi-annually, principal due in March 2009	$ 56,963	$ 57,531
Interest rate swaps fair value hedge adjustment on $60 million of 3% convertible senior notes	3,037	2,469
	60,000	60,000
Less: current portion		
Long-term portion	$ 60,000	$ 60,000

3% Convertible Senior Notes

During fiscal 2004, the Company completed the offering of $60,000,000 of 3% convertible senior notes to qualified institutional buyers in reliance on Rule 144A under the Securities Act. The notes are senior unsecured obligations of Intellisync and rank junior to any future secured debt, on a parity with all of the Company s other existing and future senior unsecured debt and prior to any existing or future subordinated debt. As of October 31, 2005, the Company had no other senior or subordinated debt, except for ordinary course trade payables. The Company may not redeem any of the notes prior to their maturity. Holders, however, may require the Company to repurchase the notes upon some types of change in control transactions. The notes will mature on March 1, 2009 unless earlier converted or redeemed. Neither the Company nor any of its subsidiaries are subject to any financial covenants under the indenture. In addition, neither the Company nor any of its subsidiaries are restricted under the indenture from paying dividends, incurring debt, or issuing or repurchasing its securities.

The notes are convertible into shares of common stock of the Company at the holders option any time prior to the close of business on the final maturity date of the notes, subject to prior redemption of the notes. The initial conversion rate is 250.0000 shares per each $1,000 principal amount of notes which represents an initial conversion price of $4.00 per share. The conversion rate is subject to adjustment for certain events, including the payment of dividends, and other events specified in the indenture.

The notes bear interest at a rate of 3% per annum. Interest on the notes is paid on March 1 and on September 1 of each year.

Interest Rate Swap

During fiscal 2004, the Company entered into two interest rate swap agreements with a financial institution on a total notional amount of $60,000,000, whereby the Company receives fixed-rate interest of 3% in exchange for variable interest payments. The interest rate swaps expire upon the maturity of the Company s $60,000,000, 3% convertible senior notes in March 2009, and effectively convert fixed-rate notes into variable-rate borrowings. The interest rate is reset semi-annually and is equal to the 6-month LIBOR rate less a rate spread. The total variable interest rate was approximately 3.8% at October 31, 2005. Under the provisions of SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*, as amended, the interest rate swaps have been designated and qualify as an effective fair value hedge of interest rate risk related to the $60,000,000 convertible senior notes. As the terms of the swaps match those of the underlying hedged debt, the changes in the fair value of these swaps are offset by corresponding changes in the carrying value of the hedged debt, and therefore do not impact the Company s net earnings. As of October 31, 2005, the fair value of the interest rate swaps was approximately $3,037,000 and recorded in Other Liabilities with an equal adjustment recorded to the carrying value of the $60,000,000 convertible senior notes.

Refer to Note 7 for the description of the collateral required on the interest rate swaps.

Note 7 Commitments and Contingencies

Leases

During fiscal 2005, the Company entered into a capital lease agreement for computer peripherals, which expires in September 2007. In addition, during fiscal 2004, the Company entered into a capital lease agreement for a phone system, which expires in February 2008. The agreements resulted in capitalized costs of $296,000 and $231,000 during fiscal 2005 and 2004, respectively. Assets and future obligations related to the capital leases are included in the accompanying condensed consolidated balance sheet as of October 31, 2005 in property and equipment and in the respective liability accounts, respectively. Current and long-term portions of the capital leases amounted to $154,000 and $173,000, respectively, at October 31, 2005. Depreciation of assets held under the capital leases is included in depreciation and amortization expense.

The Company leases its facilities under operating leases that expire at various dates through December 2008. The total amount of rental payments due over the lease term is being charged to rent on the straight-line method over the term of the lease. The difference between rent expense recorded and the amount paid is credited or charged to deferred rent which is included in current liabilities in the accompanying balance sheets. Deferred rent was approximately $203,000 and $259,000 at October 31, 2005 and July 31, 2005, respectively. Total rent expense was approximately $924,000 and $589,000 for the three months ended October 31, 2005 and 2004, respectively.

Future minimum lease payments for all non-cancelable capital and operating lease agreements at October 31, 2005, were as follows (in thousands):

		Nine months	Fiscal year ending July 31,			
	Total	**ending July 31, 2006**	**2007**	**2008**	**2009**	**2010 and Thereafter**
Capital lease obligation(1)	$ 364	$ 136	$ 182	$ 46	$	$
Operating leases:						
Operating leases	4,559	2,242	1,099	849	369	
Proceeds from subleases	(21)	(21)				
Net operating leases	4,538	2,221	1,099	849	369	
Future minimum lease payments	$ 4,902	$ 2,357	$ 1,281	$ 895	$ 369	$

(1) Includes interest payments due (interest rates ranging from 2.4% to 12.7%).

Acquisitions and Potential Earnout Payments

In June 2005, the Company completed its acquisition of all of the issued and outstanding stock of PDAapps. Under the terms of an Agreement and Plan of Merger, dated as of June 23, 2005, the outstanding shares of PDAapps common stock were converted into the right to receive (i) an aggregate of approximately $4,000,000 in aggregate initial cash consideration and (ii) an aggregate of up to $2,600,000 in cash earnout consideration (based on future revenue generated by the Company from the former PDAapps client base), subject to the deposit of $1,000,000 in escrow to be available to compensate Intellisync pursuant to the indemnification obligations of the holders of PDAapps common stock. The earnout consideration, if achieved, is due and payable shortly following the first anniversary of the acquisition.

In March 2005, the Company completed its acquisition of all of the issued and outstanding stock of Tourmaline. Under the terms of an Agreement and Plan of Merger, dated as of February 9, 2005, the outstanding shares of Tourmaline common stock were converted into the right to receive (i) an aggregate of approximately $4,118,000 in aggregate initial cash consideration and (ii) an aggregate of up to $2,881,918 in cash earnout consideration (based on future revenue generated by the Company from the former Tourmaline client base), subject to the deposit of a certain portion of the initial cash consideration and earnout consideration in escrow to be available to compensate Intellisync pursuant to the indemnification obligations of the holders of Tourmaline common stock. The earnout consideration, if achieved, is due and payable shortly following the first anniversary of the acquisition.

As of October 31, 2005, the Company has not accrued any contingent earnout payment amounts discussed above. Any earnout consideration paid will be recorded as additional goodwill associated with the respective acquisition.

Guarantees

The Company has three letters of credit that collateralize certain operating lease obligations and total approximately $281,000 and $321,000 at October 31, 2005 and July 31, 2005, respectively. The Company collateralizes these letters of credit with cash deposits made with two of its financial institutions and has classified the short-term and the long-term portions of approximately $211,000 and $70,000 at October 31, 2005, and $196,000 and $125,000 at July 31, 2005 as Other Current Assets and Restricted Cash, respectively, in the condensed consolidated balance sheets. The long-term portion expires through June 2006. The holders of the letters of credit are able to draw on each respective letter of credit in the event that the Company is found to be in default of its obligations under each of its operating leases.

Under the terms of the interest rate swap agreement into which the Company entered during fiscal 2004, the Company must provide collateral to match any unfavorable mark-to-market exposure (fair value) on the swaps. The amount of collateral required totals a minimum of $1,800,000 plus an amount equal to the unfavorable mark-to-market exposure on the swaps. Generally, the required collateral will rise as interest rates rise. As of October 31, 2005, and July 31, 2005, the Company has provided approximately $4,821,000 and $4,181,000, respectively, of collateral under this swap agreement which is included in Restricted Cash in its condensed consolidated balance sheet.

In the event of early termination of the Company s service agreement with e deltacom, a division of ITC^DeltaCom, Inc. and a managed service provider, the Company may be required to pay e deltacom a penalty fee of up to approximately $45,000.

Litigation

On October 5, 2005, Spontaneous Technology, Inc. served the Company with a complaint filed in the Third Judicial District Court, of Salt Lake County, State of Utah. In the Complaint, Spontaneous Technology asserts a cause of action for breach of contract related to the calculation of an earnout payment in the Asset Purchase Agreement entered into between the parties on July 30, 2003. Spontaneous Technology seeks compensatory damages in the amount of $673,750 and recovery of its attorneys fees and costs. The Company is investigating this matter, and at this time does not believe this matter will have a material adverse effect on its consolidated financial position, results of operation or liquidity.

The Company is party to various legal proceedings and claims, either asserted or unasserted, which arise in the ordinary course of business, including proceedings and claims that relate to acquisitions it has completed or to companies it has acquired, commercial, employment and other matters. While the outcome of these matters cannot be predicted with certainty, the Company does not believe that the outcome of any of these claims or any of the above mentioned legal matters will have a material adverse effect on its consolidated financial position, results of operations or cash flows. In accordance with generally accepted accounting principles, the Company makes a provision for a liability when it is both probable that a liability has been incurred and the amount of the loss can be reasonably estimated. These provisions are reviewed at least quarterly and adjusted to reflect the impacts of negotiations, settlements, rulings, advice of legal counsel, and other information and events pertaining to a particular case. Litigation is inherently unpredictable. However, the Company believes that it has valid defenses with respect to the legal matters pending against Intellisync. It is possible, nevertheless, that the Company s consolidated financial position, cash flows or results of operations could be affected by the resolution of one or more of these contingencies.

Note 8 Stock-Based Compensation

Effective August 1, 2005, the Company adopted SFAS No. 123(R), *Share-Based Payment*, using the modified prospective application transition method, which establishes accounting for stock-based awards exchanged for employee services. Accordingly, stock-based compensation cost is measured at grant date, based on the fair value of the award, over the requisite service period. The Company previously applied APB Opinion No. 25, *Accounting for Stock Issued to Employees,* and related Interpretations, as permitted by SFAS No. 123, *Accounting for Stock-Based Compensation.*

Pro Forma Information Under SFAS No.123 for Periods Prior to Fiscal 2006

Prior to the adoption of SFAS No. 123(R), the Company provided the disclosures required under SFAS No. 123, as amended by SFAS No. 148, *Accounting for Stock-Based Compensation Transition and Disclosures*. The Company generally did not recognize stock-based compensation expense in its statement of operations for periods prior to the adoption of SFAS No. 123(R) as most options granted had an exercise price equal to the market value of the underlying common stock on the date of grant.

Pro forma information regarding option grants made to the Company s employees and directors and employee stock purchases related to the Employee Stock Purchase Plan is as follows (in thousands, except per-share amounts):

		Three Months Ended October 31, 2004
Net loss as reported	$	(3,506)
Add: Stock-based employee compensation expense (reversal) included in reported net loss		(65)
Deduct: Total stock-based employee compensation expense determined under fair value method for all awards		(1,207)
Pro forma net loss	$	(4,778)
Basic and diluted net loss per common share as reported	$	(0.05)
Basic and diluted pro forma net loss per common share	$	(0.07)

The weighted-average estimated value of options granted under the stock option plans and shares granted under the stock purchase plan during the three months ended October 31, 2004 was $1.67 and $1.36 using the Black-Scholes model with the following weighted-average assumptions:

	Three Months Ended October 31, 2004	
	Stock Option Plans	Employee Stock Purchase Plan