IMAGE SOFTWARE INC
Form 10-Q
August 14, 2003

FORM 10-Q
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

(X) QUARTERLY REPORT PURSUANT TO SECTION 13 OF 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934. For the quarterly period ended 6/30/2003

OR

( ) TRANSITION REPORT PURSUANT TO SECTION 13 OF 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934. For the transition period from ------------------ to -------------------

1MAGE SOFTWARE, INC.
(Exact name of Registrant as specific in its charter)

0-12535
(Commission File Number)

| | |
|---|---|
| COLORADO | 84-0866294 |
| (State of Incorporation) | (IRS Employer Identification Numbers) |
| 6025 S. QUEBEC ST. SUITE 300 ENGLEWOOD CO 80111 | (303) 694-9180 |
| (Address of principal executive offices) | (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 X No

Indicate by check mark whether the Registrant is an accelerated filer (as defined in Rule 12b-2 of the Act). Yes No X

As of August 11, 2003, there were 3,274,597 shares of the Registrant's common stock outstanding.

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PART I.     FINANCIAL INFORMATION





PART I - FINANCIAL INFORMATION

ITEM 1  FINANCIAL STATEMENTS

1MAGE SOFTWARE, INC.

BALANCE SHEETS

| | Unaudited June 30, 2003 | Decem 20 |
|---|---|---|
| ASSETS | | |
| CURRENT ASSETS: | | |
| Cash and cash equivalents | $ 98,108 | $ 1 |
| Trade receivables (less allowance: 2003, $22,000; 2002, $10,000) | 517,085 | 5 |
| Inventory | 14,755 | |
| Prepaid expenses and other current assets | 23,654 | |
| Employee advances | 3,468 | |
| Total current assets | 657,070 | 7 |
| PROPERTY AND EQUIPMENT, at cost, net | 41,690 | |
| OTHER ASSETS: | | |
| Software development costs, net | 701,179 | 7 |
| Deferred tax asset | 50,000 | |
| Loan costs, net | 34,569 | |
| Inventory: long-term | 2,958 | |
| Rent/Security deposits | 7,841 | |

| | | |
|---|---|---|
| TOTAL ASSETS | $ 1,495,307 | $ 1,5 |
| LIABILITIES AND SHAREHOLDERS' EQUITY | | |
| CURRENT LIABILITIES: | | |
| Line of credit - bank | $ 190,000 | $ |
| Current portion of capital lease obligations | 3,663 | |
| Deferred revenue | 270,000 | 2 |
| Accounts payable | 166,973 | 2 |
| Accrued liabilities | 120,602 | 1 |
| Total current liabilities | 751,238 | 7 |
| LONG-TERM OBLIGATIONS: | | |
| Capital lease obligations | 7,105 | |
| Line of credit - related party | 40,000 | 2 |
| | 47,105 | 2 |
| COMMITMENTS AND CONTINGENCIES | | |
| SHAREHOLDERS' EQUITY: | | |
| Common stock, $.004 par value - 10,000,000 shares authorized; shares outstanding: 2003: 3,274,597; 2002: 3,146,554 | 13,098 | |
| Additional paid-in capital | 7,284,035 | 7,2 |
| Accumulated deficit | (6,600,169) | (6,6 |
| Total shareholders' equity | 696,964 | 6 |
| TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY | $ 1,495,307 | $ 1,5 |

See Notes to Condensed Financial Statements



1MAGE SOFTWARE, INC.
STATEMENTS OF OPERATIONS
(UNAUDITED)

| | Three Months Ended June 30, 2003 | 2002 |
|---|---|---|
| REVENUE | | |
| System sales and software licenses | $ 246,294 | $ 253,702 |
| Services and annual fees | 261,066 | 356,263 |
| Total revenue | 507,360 | 609,965 |
| COST OF REVENUE: | | |
| System sales and software licenses | 133,819 | 166,319 |
| Services and annual fees | 93,494 | 133,156 |
| Total cost of revenue | 227,313 | 299,475 |
| GROSS PROFIT | 280,047 | 310,490 |

| | | |
|---|---|---|
| % Of Revenue | 55% | 51% |
| OPERATING EXPENSES: | | |
| Selling, general & administrative | 313,195 | 392,886 |
| INCOME/(LOSS) FROM OPERATIONS | (33,148) | (82,396) |
| OTHER INCOME/(EXPENSE): | | |
| Interest income | 1,143 | 1,052 |
| Interest expense | (4,041) | (2,352) |
| Total other income (expense) | (2,898) | (1,300) |
| INCOME/(LOSS) BEFORE INCOME TAXES | (36,046) | (83,696) |
| PROVISION FOR INCOME TAXES | -- | -- |
| NET INCOME/(LOSS) | $ (36,046) | $ (83,696) |
| BASIC AND DILUTED INCOME/(LOSS) PER COMMON SHARE: | $ (.01) | $ (.03) |
| WEIGHTED AVERAGE NUMBER OF COMMON SHARES OUTSTANDING: | | |
| Basic | 3,244,927 | 3,146,554 |
| Diluted | 3,244,927 | 3,146,554 |

See Notes to Condensed Financial Statements



1MAGE SOFTWARE, INC.
STATEMENTS OF OPERATIONS
(UNAUDITED)

| | Six Months Ended June 30, 2003 | 2002 |
|---|---|---|
| REVENUE | | |
| System sales and software licenses | $ 398,284 | $ 465,778 |
| Services and annual fees | 537,744 | 661,451 |
| Total revenue | 936,028 | 1,127,229 |
| COST OF REVENUE: | | |
| System sales and software licenses | 251,636 | 379,157 |
| Services and annual fees | 185,705 | 254,854 |

| | | |
|---|---|---|
| Total cost of revenue | 437,341 | 634,011 |
| GROSS PROFIT | 498,687 | 493,218 |
| % Of Revenue | 53% | 44% |
| OPERATING EXPENSES: | | |
| Selling, general & administrative | 622,617 | 720,183 |
| INCOME/(LOSS) FROM OPERATIONS | (123,930) | (226,965) |
| OTHER INCOME/(EXPENSE): | | |
| Interest income | 1,593 | 1,855 |
| Interest expense | (8,092) | (2,900) |
| Other income | 138,519 | -- |
| Total other income (expense) | 132,020 | (1,045) |
| INCOME/(LOSS) BEFORE INCOME TAXES | 8,090 | (228,010) |
| PROVISION FOR INCOME TAXES | -- | -- |
| NET INCOME/(LOSS) | $ 8,090 | $ (228,010) |
| BASIC AND DILUTED INCOME/(LOSS) PER COMMON SHARE: | $ 0.00 | $ (.07) |
| WEIGHTED AVERAGE NUMBER OF COMMON SHARES OUTSTANDING: | | |
| Basic | 3,197,062 | 3,146,554 |
| Diluted | 3,203,950 | 3,146,554 |

See Notes to Condensed Financial Statements

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1MAGE SOFTWARE, INC.
STATEMENTS OF CASH FLOWS
(UNAUDITED)

| | Six Months Ended June 30, 2003 | 2002 |
|---|---|---|
| CASH FLOWS FROM OPERATING ACTIVITIES: | | |
| Net Earnings/(Loss) | $ 8,090 | $ (228,010) |
| Adjustments to reconcile earnings to net cash provided by operating activities: | | |
| Depreciation and amortization | 164,052 | 162,305 |
| Settlement of payable | (138,375) | -- |

| | | |
|---|---|---|
| Deferred revenue | (11,000) | 31,000 |
| Issuance of stock for services or fees | 7,000 | -- |
| Changes in assets and liabilities: | | |
| Trade receivables | 32,370 | 1,779 |
| Inventory | 1,745 | 1,018 |
| Prepaid expenses and other assets | (11,460) | (3,817) |
| Accounts payable | 27,174 | 82,671 |
| Accrued expenses | (27,658) | (29,598) |
| Net cash provided by operating activities | 51,938 | 17,348 |
| CASH FLOWS FROM INVESTING ACTIVITIES: | | |
| Purchase of property and equipment | (2,245) | (12,594) |
| Additions to capitalized software | (130,863) | (157,719) |
| Net cash used in investing activities | (133,108) | (170,313) |
| CASH FLOWS FROM FINANCING ACTIVITIES: | | |
| Additions to line of credit | 40,000 | 175,000 |
| Repayment of line of credit | (10,000) | -- |
| Repayment of long-term obligations | (460) | (1,248) |
| Net cash provided by financing activities | 29,540 | 173,752 |
| DECREASE IN CASH AND CASH EQUIVALENTS | (51,630) | 20,787 |
| CASH AND CASH EQUIVALENTS, beginning of period | 149,738 | 212,421 |
| CASH AND CASH EQUIVALENTS, end of period | $ 98,108 | $ 233,208 |
| SUPPLEMENTAL CASH FLOWS INFORMATION | | |
| Issuance of stock and stock purchase warrants for deferred loan origination fees related to the DEMALE, LLC line of credit | $ 38,889 | $ -- |

See Notes to Condensed Financial Statements



1MAGE SOFTWARE, INC.

NOTES TO INTERIM FINANCIAL STATEMENTS

GENERAL:

Management has elected to omit substantially all notes to the unaudited interim financial statements. Reference should be made to the Company's annual report on Form 10-K for the year ended December 31, 2002 as this report incorporates the Notes to the Company's year-end financial statements. The condensed balance sheet of the Company as of December 31, 2002 has been derived from the audited balance sheet of the Company as of that date.

UNAUDITED INTERIM INFORMATION:

The unaudited interim financial statements contain all necessary adjustments (consisting of only normal recurring adjustments) which, in the opinion of Management, are necessary for a fair statement of the results for the interim periods presented. The results of operations for the interim periods presented are not necessarily indicative of those expected for the year.

REVENUE RECOGNITION - Revenue from the sale of software licenses, computer equipment, and existing application software packages is recognized when the software and computer equipment are shipped to the customer, remaining vendor obligations are insignificant, there are no significant uncertainties about customer acceptance and collectibility is probable. Revenue from related services, including installation and software modifications, is recognized upon performance of services. Maintenance revenue is recognized ratably over the maintenance period.

INCOME TAXES - The Company follows the liability method of accounting for income taxes in accordance with Statement of Financial Accounting Standards (SFAS) No. 109. Under this method, deferred income taxes are recorded based upon differences between the financial reporting and tax bases of assets and liabilities and are measured using enacted tax rates and laws that will be in effect when the underlying assets or liabilities are received or settled.

The Company has recorded a valuation allowance against the deferred tax assets due to the uncertainty of ultimate realizability.

EARNINGS (LOSS) PER SHARE - Earnings/ (Loss) per share is computed by dividing net income (loss) by the weighted average number of common and equivalent shares outstanding during the period. Outstanding stock options and stock purchase warrants are treated as common stock equivalents for purposes of computing diluted earnings per share. As the Company incurred net losses for the three months ended June 30, 2003 and for the three and six months ended June 30, 2003, the outstanding stock options are antidilutive and have been excluded from the computation of diluted earnings per share. For the six months ended June 30, 2003, approximately 7,000 outstanding stock options are considered dilutive and are included in the denominator for the computation of diluted earnings per share. As the exercise price for the stock purchase warrants issued on April 1, 2003 is less than the average market price for the three and six months ended June 30, 2003, the stock purchase warrants are considered antidilutive and have been excluded from the computation of diluted earnings per share.



| | For the Six Months Ended June 30, | | For the Three Months Ended June 30, | |
|---|---|---|---|---|
| | 2003 | 2002 | 2003 | 2002 |
| Net income (loss), as reported | $ (36,046) | $ (83,696) | $ 8,090 | $ (228,010) |
| Less: Total stock-based employee compensation cost determined under the fair value based method, net of income taxes | (28,281) | (22,953) | (43,354) | (45,905) |
| Pro forma net income (loss) | $ (64,327) | $(106,649) | $(35,264) | $ (273,915) |
| Earnings per share: | | | | |

| | | | | |
|---|---|---|---|---|
| Basic and Diluted - as reported | $ (.01) | $ (.03) | $ .00 | $ (.07) |
| Basic and Diluted - pro forma | $ (.02) | $ (.03) | $ (.01) | $ (.09) |

LINE OF CREDIT - RELATED PARTY - On April 1, 2003, the Company entered into a $300,000 revolving line-of-credit agreement (the Agreement) with DEMALE, LLC, an entity owned by certain stockholders of the Company. In connection with the Agreement, the Company issued 90,000 shares of restricted common stock and stock purchase warrants to purchase an additional 90,000 shares of restricted common stock as payment for loan origination costs. The line expires on June 30, 2005 and requires the Company, among other things, to maintain certain financial conditions. At June 30, 2003, there was $40,000 borrowed against this line. The line is secured by substantially all of the Company's assets and is subordinate to the bank line of credit. Interest is accrued at prime plus 1 1/2% (6.75% at June 30, 2003) but may not be less than 7%; therefore, at June 30, 2003, interest was being accrued at 7%.



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

RESULTS OF OPERATIONS FOR THREE MONTHS ENDED JUNE 30, 2003 VERSUS JUNE 30, 2002
The Company's revenue for second quarter 2003 was $507,000 compared to $610,000 for the second quarter 2002, representing a decrease of $103,000 (17%). The Company's revenue decreased $101,000 for the second quarter as a result of the loss of the Company's largest customer, Reynolds and Reynolds ("Reynolds"). The Company does not anticipate any significant revenue from Reynolds in 2003. Revenue from new business for the second quarter of 2003 was $273,000, an increase of $113,000 (71%), as compared to new business revenue of $160,000 for the second quarter of 2002. Revenue from sales of software licenses was $205,000 in 2003, a 14% increase over $180,000 in 2002. This increase was offset by a $33,000 decrease in low-margin hardware sales. Consulting services of $38,000 were significantly lower than $90,000 reported for second quarter 2002 due to fluctuations in customers requiring these services, which may vary from quarter to quarter. Recurring license fees decreased 16% or $43,000, of which a decrease of $101,000 was attributable to the loss of Reynolds; however, without the loss of this customer, annual license fees would have increased 35% or $58,000. SG&A expenses of $313,000 for the second quarter were $80,000 (20%) lower than the $393,000 reported for the second quarter of 2002, primarily due to decreased expenses across the board. The Company reported a second quarter 2003 net loss of $(36,000), or $(.01) per share, as compared to a net loss of $(84,000), or $(.03) per share, for the same quarter last year.

| | Three Months Ended 6/30/03 | Three Months Ended 6/30/02 | Increase/ Decrease) $ | Increase/ (Decrease) % |
|---|---|---|---|---|
| Revenue (as reported) | $ 507,360 | $ 609,965 | $(102,605) | (17%) |
| Less: Reynolds revenue | 0 | 101,222 | (101,222) | (100%) |
| Revenue excluding Reynolds | $ 507,360 | $ 508,743 | $ (1,383) | 0% |

RESULTS OF OPERATIONS FOR SIX MONTHS ENDED JUNE 30, 2003 VERSUS JUNE 30, 2002
The Company reported revenue of $936,000 for the six months ended June 30, 2003, a decrease of $191,000, or 17%, from the $1.1 million reported for the first six months in 2002. The year to date revenue decreased $326,000 in 2003 as the result of the loss of Reynolds as a customer. Without the loss of Reynolds, revenue would have increased $121,000, or 15%. The combination of revenue and cost of revenue components, however, caused the gross profit to decrease only $5,500 for the comparable year to date periods. Software sales decreased $46,000, or 13%, of which $121,000 is attributable to Reynolds. Hardware sales decreased $21,000, or 20% as a result of customers' varying needs for equipment. Annual license fees decreased $104,000, or 20%, of which $192,000 was attributable to Reynolds. Without the loss of this customer, annual license fees would have increased $88,000, or 27%. For the six months ended June 30, 2003, gross profit as a percent of revenue was 53%, as compared to 44% for the year earlier period. SG&A expenses of $623,000 for the second quarter 2003 were $97,000 or 13% lower than $720,000 for the six months ended June 30, 2003, primarily due to decreased salaries, marketing costs and travel expenses. The Company reported net income of $8,000, or $.00 per share, for the



six months ended June 30, 2003, as compared to a net loss of $(228,000), or $(.07) per share, for the same period one year ago.

In first quarter 2003, the Company settled a liability of $139,000, which is included in other income, that related to a volume sale from a prior year that was tied to the purchase of future software licenses.

| | Six Months Ended 6/30/03 | Six Months Ended 6/30/02 | Increase/ (Decrease) $ | Increase/ (Decrease) % |
|---|---|---|---|---|
| Revenue (as reported) | $ 936,028 | $ 1,127,229 | $ (191,201) | (17%) |
| Less: Reynolds revenue | 13,318 | 325,896 | (312,578) | (96%) |
| Revenue excluding Reynolds | $ 922,710 | $ 801,333 | $ 121,377 | 15% |

See the discussion of the effect of the loss of Reynolds in "Liquidity and Capital Resources" below.

LIQUIDITY AND CAPITAL RESOURCES

The Company's cash and cash equivalents of $98,000 at June 30, 2003 represented a decrease of approximately $52,000, as compared to December 31, 2002. During 2003, the Company used cash of $131,000 for deferred development expenses. The Company had a working capital deficit of $94,000 as of June 30, 2003. The Company believes there is sufficient working capital to operate the business because the "Deferred Revenue" liability consists of $270,000 that is not immediately due and payable; rather it represents payments on annual maintenance contracts that will be earned over the next twelve months. As the ongoing litigation between the Company and Reynolds is being handled by legal counsel on a contingency basis plus direct expenses, legal fees incurred by the Company related to the Reynolds litigation are not due or payable until the litigation has been settled, at which time the fees will be deducted from the proceeds, if any. Management believes that the Company has the liquidity to fund the direct expenses related to the litigation.

The Company's bank line of credit was $190,000 at June 30, 2002, compared to $200,000 at December 31, 2002. The line matures in February 2004 and is collateralized by all accounts receivable and general intangibles of the Company.

In addition, the Company has a line of credit of up to $300,000 with DEMALE, LLC. As of June 30, 2003, there were borrowings of $40,000 against this line. The loan is secured by a junior interest in the collateral backing the bank line of credit.

As noted above in "Results of Operations", the termination by Reynolds of its 1996 Subscription and Maintenance Agreement and the resulting loss of Reynolds as a customer has already had a significantly adverse impact on the Company's revenue. There has been a corresponding adverse impact on cash flow and liquidity. The Company has not yet replaced all of the revenue lost as a result of the termination of the 1996 contract and by Reynolds' subsequent actions.



However, it is possible that some portion of that lost revenue will be awarded to the Company in the ongoing litigation between the Company and Reynolds. Naturally, the Company cannot predict the outcome of that litigation nor can there be any assurance that the Company will ever obtain a meaningful recovery from Reynolds.

The Company's financial resources include cash on hand, revenues from operations, and management of funds available on its revolving lines of credit. In the Company's judgment, sufficient financial resources are available to meet current working capital needs.

FORWARD LOOKING STATEMENTS

Some of the statements made herein are not historical facts and may be considered "forward looking statements." All forward-looking statements are, of course, subject to varying levels of uncertainty. In particular, statements which suggest or predict future events or state the Company's expectations or assumptions as to future events may prove to be partially or entirely inaccurate, depending on any of a variety of factors, such as adverse economic conditions, new technological developments, competitive developments, competitive pressures, unanticipated results or costs of ongoing litigation, changes in the management, personnel, financial condition or business objectives of one or more of the Company's customers, increased governmental regulation or other actions affecting the Company or its customers as well as other factors.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK - INAPPLICABLE

ITEM 4. CONTROLS AND PROCEDURES

Disclosure Controls and Procedures

Within the 90 days prior to the date of this report, the Company carried out an evaluation, under the supervision and participation of the Company's Chief Executive Officer and Chief Financial Officer (the "Officers") of the effectiveness of the design and operation of the Company's disclosure controls and procedures pursuant to Securities Exchange Act Rule 13a-14. Based upon that evaluation, the Officers concluded that the Company's disclosure controls and procedures are effective in timely alerting them to material information relating to the Company required to be included in the Company's periodic SEC filings, including this report.

Internal Controls
There were no significant changes made in the Company's internal controls or in other factors that could significantly affect these controls subsequent to the date of their evaluation.

## PART II: OTHER INFORMATION

### ITEM 1. LEGAL PROCEEDINGS

In the pending civil action brought by the Company in federal district court in Colorado against the Reynolds & Reynolds Company ("Reynolds") and certain automobile dealer-customers of Reynolds for infringing use of the Company's software, Reynolds filed a motion to compel arbitration of the Company's claims against Reynolds on the grounds that it was required by the 1994 Software Licensing Agreement between the parties. 1MAGE SOFTWARE, INC. V. THE REYNOLDS AND REYNOLDS COMPANY, ET AL., U.S.D.C., D.Colo., Civ. No. 02-K-1688. On July 13, 2003, Judge John L. Kane granted Reynolds' motion and the automobile dealer defendants' related motion to stay the civil action against them pending the results of mediation or arbitration between the Company and Reynolds. While the court retained jurisdiction over the case and is requiring quarterly status reports, Judge Kane's ruling means that the Company will at least



initially be pursuing its claims against Reynolds in arbitration. Further judicial proceedings against the automobile dealers and Reynolds remain a possibility, however, depending on the outcome of the arbitration.

| | | |
|---|---|---|
| ITEM 2. | CHANGES IN SECURITIES AND USE OF PROCEEDS | INAPPLICABLE |
| ITEM 3. | DEFAULTS UPON SENIOR SECURITIES | INAPPLICABLE |
| ITEM 4 | SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS | INAPPLICABLE |
| ITEM 5. | OTHER INFORMATION | INAPPLICABLE |
| ITEM 6. | EXHIBITS AND REPORTS ON FORM 8-K | |

(A) EXHIBIT TABLE

| | |
|---|---|
| 31.1 | CERTIFICATE OF CHIEF EXECUTIVE OFFICER PURSUANT TO SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002 |
| 31.2 | CERTIFICATE OF CHIEF FINANCIAL OFFICER PURSUANT TO SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002 |
| 32 | CERTIFICATE OF CEO AND CFO PURSUANT TO SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002 |

(B) REPORTS ON FORM 8-K

A Form 8-K dated April 30, 2003 under Item 5 was filed May 2, 2003.

## SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

1MAGE SOFTWARE, INC.
(Registrant)

Date: 8/14/2003 /S/ DAVID R. DEYOUNG

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David R. DeYoung
President, Principal and Chief Executive Officer

Date: 8/14/2003 /S/ MARY ANNE DEYOUNG

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Mary Anne DeYoung
Vice President, Finance and Principal Financial Officer