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IMAGE SOFTWARE INC
Form 10-Q
May 17, 2004

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 3/31/2004
OR
() TRANSITION REPORT PURSUANT TO SECTION 13 OF 15(D) OF THE SECURITIES
EXCHANGE ACT OF 1934. For the transition period from _____ to _____

IMAGE SOFTWARE, INC.

(Exact name of Registrant as specified in its charter)
0-12535

(Commission File Number)

COLORADO

84-0866294

(State of Incorporation)

(IRS Employer Identification Number)

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 May 9, 2004, there were 3,302,597 shares of the Registrant's Common
Stock outstanding.

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PART I - FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

IMAGE SOFTWARE, INC. BALANCE SHEETS

	Unaudited March 31, 2004	December 31, 2003

ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	\$ 60,473	\$ 143,505
Receivables:		
Trade (less allowance: 2004, \$25,000; 2003, \$20,000)	630,459	609,216
Deferred tax asset	20,000	20,000
Prepaid expenses and other current assets	39,489	55,457
Inventory	15,049	11,517
Employee advances	3,419	19,631
	-----	-----
Total current assets	768,889	859,326
PROPERTY AND EQUIPMENT, at cost, net	43,948	43,465
OTHER ASSETS:		
Software development costs, net	684,248	694,262
Loan costs, net	21,609	25,929
Deferred tax asset	40,000	40,000
Rent/security deposit	7,841	7,841
Inventory	2,958	2,958
	-----	-----
TOTAL ASSETS	\$ 1,569,493	\$ 1,673,781
	=====	=====

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LIABILITIES AND SHAREHOLDERS' EQUITY

CURRENT LIABILITIES:

Line of credit	\$	190,000	\$	--
Current portion of capital lease obligations		4,161		3,663
Deferred revenue		277,000		287,000
Accounts payable		134,628		162,255
Accrued liabilities		217,183		230,958

Total current liabilities

822,972 683,876

LONG-TERM OBLIGATIONS:

Capital lease obligations		7,898		7,105
Line of credit-Bank		--		139,314
Line of credit-Related Parties		104,600		54,600

112,498 201,019

SHAREHOLDERS' EQUITY:

Common stock, \$.004 par value - 10,000,000

shares authorized;

shares outstanding: 2004 - 3,287,597;

2003 - 3,287,597

13,150 13,150

Additional paid-in capital

7,288,455 7,288,455

Accumulated deficit

(6,667,582) (6,512,719)

Total shareholders' equity

634,023 788,886

TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY

\$ 1,569,493 \$ 1,673,781

See Notes to Condensed Financial Statements

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IMAGE SOFTWARE, INC. STATEMENTS OF OPERATIONS (UNAUDITED)

Three Months Ended March 31,
2004 2003

REVENUE

System sales and software licenses	\$	156,007	\$	151,990
Services and annual fees		287,737		276,678

Total revenue

443,744 428,668

COST OF REVENUE

System sales and software licenses	102,265	117,817
Services and annual fees	138,051	92,211

Total cost of revenue

240,316 210,028

GROSS PROFIT

203,428 218,640

% of Revenue

46% 51%

OPERATING EXPENSES:

Selling, general & administrative	349,269	309,422
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LOSS FROM OPERATIONS	(145,841)	(90,782)
	-----	-----
OTHER INCOME/(EXPENSE):		
Interest expense	(9,104)	(4,051)
Interest income	82	594
Other income	--	138,375
	-----	-----
Total other income (expense)	(9,022)	134,918
	-----	-----
INCOME/(LOSS) BEFORE INCOME TAXES	(154,863)	44,136
PROVISION FOR INCOME TAXES	--	--
	-----	-----
NET INCOME/(LOSS)	\$ (154,863)	\$ 44,136
	=====	=====
BASIC AND DILUTED INCOME/(LOSS) PER COMMON SHARE:	\$ (.05)	.01
	=====	=====
WEIGHTED AVERAGE NUMBER OF COMMON SHARES OUTSTANDING:	3,287,597	3,175,738
	=====	=====

See Notes to Condensed Financial Statements

IMAGE SOFTWARE, INC. STATEMENTS OF CASH FLOWS (UNAUDITED)

	Three Months Ended March 31, 2004	2003
	-----	-----
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net Earnings/(Loss)	\$ (154,863)	\$ 44,136
Adjustments to reconcile earnings to net cash provided by operating activities:		
Depreciation and amortization	84,093	79,893
Deferred revenue	(10,000)	(26,000)
Settlement of payable	0	(138,375)
Issuance of stock for services	0	7,000
Changes in assets and liabilities:		
Receivables	(21,243)	11,911
Inventory	(3,532)	224
Prepaid expenses and other assets	32,180	3,656
Accounts payable	(27,627)	13,366
Accrued liabilities	(13,775)	(25,348)
	-----	-----
Net cash used for operating activities	(114,767)	(29,537)
	-----	-----
CASH FLOWS FROM INVESTING ACTIVITIES:		

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Purchase of property and equipment	(2,963)	(1,323)
Additions to capitalized software	(65,286)	(64,988)
	-----	-----
Net cash used for investing activities	(68,249)	(66,311)
	-----	-----
CASH FLOWS FROM FINANCING ACTIVITIES:		
Additions to the line of credit- Bank	50,686	--
Additions to the line of credit- Related Party	50,000	--
Principal payments under capital lease obligations	(702)	(460)
	-----	-----
Net cash provided by (used for) financing activities	99,984	(460)
	-----	-----
DECREASE IN CASH AND CASH EQUIVALENTS	(83,032)	(96,308)
CASH AND CASH EQUIVALENTS, beginning of period	143,505	149,738
	-----	-----
CASH AND CASH EQUIVALENTS, end of period	\$ 60,473	\$ 53,430
	=====	=====

See Notes to Condensed Financial Statements

Supplemental Cash Flows Information

Capital lease obligation incurred for equipment	\$ 1,993	\$	--
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IMAGE 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, 2003 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, 2003 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

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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 are treated as common stock equivalents for purposes of computing diluted earnings per share. As the average market price during the period ended March 31, 2003 was less than the lowest exercisable option price, the outstanding stock options were antidilutive and have been excluded from the computation of diluted earnings per share. As the Company incurred a net loss for the period ended March 31, 2004, the outstanding stock options and stock purchase warrants were antidilutive and have been excluded from the computation of diluted earnings per share.

STOCK-BASED COMPENSATION - At December 31, 2003, the Company has three stock-based employee compensation plans. The Company accounts for these plans under the recognition and measurement principles of APB Opinion No. 25, Accounting for Stock Issued to Employees, and related Interpretations. No stock-based employee compensation cost is reflected in net income, as all options granted under those plans had an exercise price equal to the market value of the underlying common stock on the grant date. The following table illustrates the effect on net income and earnings per share if the Company had applied the fair value provisions of FASB Statement No. 123, Accounting for Stock-Based Compensation, to stock-based employee compensation.

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	For the three months ended March 31	
	2004	2003
Net income (loss), as reported	\$ (154,863)	\$ 44,136
Less: Total stock-based employee compensation cost determined under the fair value based method, net of income taxes	(5,807)	(15,073)
Pro forma net income (loss)	\$ (160,670)	\$ 29,063
Earnings/(loss) per share:		
Basic and Diluted - as reported	\$ (0.05)	\$ 0.01
Basic and Diluted - pro forma	\$ (0.05)	\$ 0.01

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,

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an entity owned by certain stockholders of the Company. The line expires on June 30, 2005 and requires the Company, among other things, to maintain certain financial conditions. At March 31, 2004, there was \$104,600 borrowed against this line. The line is secured by substantially all of the Company's assets but is subordinated to the bank line of credit, which holds a senior lien on the same assets. Interest is accrued and payable quarterly at prime plus 1 1/2% (6.5% at March 31, 2004) but may not be less than 7%; therefore, at March 31, 2004, interest was being accrued at 7%.

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OVERVIEW

Image Software, Inc. (the "Company") continues to face the challenge of consistently generating revenues at or above the level it achieved prior to the termination by Reynolds & Reynolds, Inc., its largest customer, of the 1996 Subscription and Maintenance Agreement with the Company. As a result of Reynolds' actions, which included the continued use by Reynolds' customers of the Company's software notwithstanding the termination of the contract and the cessation of payments by Reynolds to the Company for such use, the Company's revenues were dramatically reduced. Revenues from the Company's new customers since that time, which would have otherwise represented business growth, have been used instead to sustain operations. While the Company has brought legal action against Reynolds on various grounds, a successful resolution of that legal action is uncertain. Accordingly, the Company has focused on the development of new customers and new markets over the past few years, with mixed success.

The Company's \$155,000 net loss for the recent quarter represents a setback for the Company's efforts to achieve a consistent record of profitability in the post-Reynolds era. Because the Company has limited capital resources, namely a bank line of credit and a private line of credit from its shareholders, it cannot sustain such losses indefinitely without an adverse effect on its liquidity and operations. Thus, the Company plans to redouble its sales efforts and reduce non-essential expenses as part of its efforts to re-establish a consistent record of profitability.

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

RESULTS OF OPERATIONS FOR THREE MONTHS ENDED MARCH 31, 2004 VERSUS MARCH 31, 2003

The Company reported revenue of \$444,000 for the first quarter of 2004, a \$15,000 increase (4%) from \$429,000 posted for the first quarter in 2003. This increase was due to a \$35,000 (33%) increase in revenue from software licenses and a \$36,000 (50%) increase in service revenue. However, due to higher compensation expenses and no other income in the first quarter of 2004, the Company posted a net loss of \$155,000 or \$(.05) per share, as compared to net income of \$44,000, or \$.01 per share, for the same quarter a year ago. In the first quarter 2003, the Company received \$138,000 settlement of a disputed claim, which amount was reported as other income, that related to a volume purchase from a prior year that was tied to the acquisition of future software licenses.

Annual license fee revenue of \$179,000 for the first quarter was 12% lower than the \$204,000 reported in the preceding year due to the timing of revenue recognition for certain customers. Revenue from hardware sales of \$13,000 decreased \$31,000 (71%) over the same quarter in 2003. SG&A expenses of \$349,000

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were \$40,000 (13%) greater than the same quarter in 2003, primarily due to increases in compensation expenses, travel and legal expenses.

LIQUIDITY AND CAPITAL RESOURCES

The Company's cash and cash equivalents of \$60,000 decreased approximately \$84,000 during the three months ended March 31, 2004 as compared to December 31, 2003. During 2004, the Company used cash of \$65,000 for deferred development expenses. The Company had a working capital deficit of \$54,000 as of March 31, 2004, versus working capital of \$175,450 as of December 31, 2003 and a working capital deficit of \$108,000 as of March 31, 2003. The decline in working capital during the quarter is attributable to the reclassification of the Company's bank line of credit as short term debt since it matures in February 2005. Included in current

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liabilities is \$277,000 for Deferred Revenue, which represents payments on annual maintenance contracts that will be earned over the next twelve months. The Company had drawn \$190,000 on its bank line of credit as of March 31, 2004. The \$200,000 bank line matures in February, 2005 and is collateralized by all accounts receivable and general intangibles of the Company. In addition, as of March 31, 2004, the Company had drawn \$104,600 on its line of credit with DEMALE, a related party. This private line of credit has a cap of \$300,000, expires in June, 2005, and is secured by a second lien on the same assets as the bank line of credit.

As noted above, the termination by Reynolds of its 1996 Subscription and Maintenance Agreement and the resulting loss of Reynolds as a customer has had a material adverse impact on the Company's revenue. There has been a corresponding adverse impact on cash flow and liquidity. While the Company has not replaced all of the revenue lost as a result of the termination of the 1996 contract and Reynolds' subsequent actions, 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. Such an award could provide a meaningful addition to the Company's capital resources. 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, 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

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ITEM 4. CONTROLS AND PROCEDURES

Internal Controls

As of the end of the period reported on in this report, the company has undertaken an evaluation under the supervision and with the participation of management, including the Company's Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of the Company's disclosure controls and procedures pursuant to Rule 13a-15 of the Securities Exchange Act of 1934. Based upon that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures were effective, in all material respects, with respect to the recording, processing, summarizing and reporting, within the time periods specified in the SEC's rules and forms, of information required to be disclosed by the Company in the reports that it files or submits under the Exchange Act.

There have been no significant changes in the Company's internal controls during the quarter ended March 31, 2004, or in other factors that could significantly affect internal controls subsequent to the date of the evaluation described above.

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PART II: OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS	INAPPLICABLE
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

There were no reports filed on Form 8-K for the quarter ended March 31, 2004.

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.

IMAGE SOFTWARE, INC.
(Registrant)

Date: 5/17/2004

/S/ DAVID R. DEYOUNG

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David R. DeYoung
President, Principal and Chief
Executive Officer

Date: 5/17/2004

/S/ MARY ANNE DEYOUNG

Mary Anne DeYoung
Vice President, Finance and
Principal Financial Officer