SMITH MICRO SOFTWARE INC
Form 10-Q
May 10, 2007

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

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

FOR THE QUARTER ENDED MARCH 31, 2007

o **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

COMMISSION FILE NUMBER 0-26536
SMITH MICRO SOFTWARE, INC.
(EXACT NAME OF REGISTRANT AS SPECIFIED IN ITS CHARTER)

DELAWARE	**33-0029027**
(STATE OR OTHER JURISDICTION OF ORGANIZATION)	(I.R.S. EMPLOYER INCORPORATION OR IDENTIFICATION NUMBER)

51 COLUMBIA, SUITE 200, ALISO VIEJO, CA	**92656**
(ADDRESS OF PRINCIPAL EXECUTIVE OFFICES)	(ZIP CODE)

REGISTRANT S TELEPHONE NUMBER, INCLUDING AREA CODE: (949) 362-5800

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 þ NO o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b of the Exchange Act. (check one):

Large accelerated filer o Accelerated filer þ Non-accelerated filer o

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

YES o NO þ

As of April 25, 2007 there were 29,631,649 shares of Common Stock outstanding.

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PART I FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

SMITH MICRO SOFTWARE, INC.
CONSOLIDATED BALANCE SHEETS
(In Thousands, Except Share and Per Share Data)

	March 31, 2007 (unaudited)	December 31, 2006 (A)
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	$ 94,046	$ 92,564
Accounts receivable, net of allowances for doubtful accounts and other adjustments of $483 (2007) and $500 (2006)	9,095	9,828
Income Tax Receivable	122	122
Deferred Tax Asset	90	90
Inventories, net of reserves for obsolete inventory of $115 (2007) and $82 (2006)	622	857
Prepaid expenses and other current assets	640	308
Total current assets	104,615	103,769
Equipment and improvements, net	505	417
Goodwill	24,501	15,266
Intangible assets, net	6,149	3,788
Deferred Tax Asset	6,191	7,786
Total assets	$ 141,961	$ 131,026
LIABILITIES AND STOCKHOLDERS EQUITY		
CURRENT LIABILITIES:		
Accounts payable	$ 2,294	$ 2,941
Accrued liabilities	2,990	2,028
Total current liabilities	5,284	4,969
COMMITMENTS AND CONTINGENCIES		
STOCKHOLDERS EQUITY:		
Preferred stock, par value $0.001 per share; 5,000,000 shares authorized; none issued or outstanding		
Common stock, par value $0.001 per share; 50,000,000 shares authorized; 29,632,000 and 28,444,000 shares issued and outstanding at March 31, 2007	30	28

and December 31, 2006, respectively				
Additional paid-in capital		137,794		129,018
Accumulated deficit		(1,147)		(2,989)
Stockholders equity		136,677		126,057
Total liabilities and stockholders equity	$	141,961	$	131,026

(A) DERIVED FROM THE AUDITED CONSOLIDATED FINANCIAL STATEMENTS AT DECEMBER 31, 2006 SEE ACCOMPANYING NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS.

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SMITH MICRO SOFTWARE, INC.
CONSOLIDATED STATEMENTS OF OPERATIONS
(In Thousands, Except Per Share Data)

	Three Months Ended March 31,	
	2007	**2006**
	(Unaudited)	**(Unaudited)**
NET REVENUES	$ 17,667	$ 9,885
COST OF REVENUES	5,679	3,299
GROSS PROFIT	11,988	6,586
OPERATING EXPENSES:		
Selling and marketing	3,459	1,873
Research and development	2,723	1,677
General and administrative	3,595	1,409
Total operating expenses	9,777	4,959
OPERATING INCOME	2,211	1,627
INTEREST INCOME	1,226	224
INCOME BEFORE INCOME TAXES	3,437	1,851
INCOME TAX EXPENSE	1,595	39
NET INCOME	$ 1,842	$ 1,812
NET INCOME PER SHARE, basic	$ 0.06	$ 0.08
WEIGHTED AVERAGE NUMBER OF SHARES OUTSTANDING, basic	29,051	22,303
NET INCOME PER SHARE, diluted	$ 0.06	$ 0.07
WEIGHTED AVERAGE NUMBER OF SHARES OUTSTANDING, diluted	30,684	24,284

SEE ACCOMPANYING NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS.

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SMITH MICRO SOFTWARE, INC.
CONSOLIDATED STATEMENT OF STOCKHOLDERS EQUITY
(In Thousands)

	Common stock		Additional paid-in	Accumulated	
	Shares	Amount	capital	deficit	Total
BALANCE, December 31, 2006	28,444	$ 28	$ 129,018	$ (2,989)	$ 126,057
Exercise of common stock options (unaudited)	331		1,198		1,198
Issuance of common stock in secondary offering, net of offering costs (unaudited)	387	1	5,346		5,347
Non cash compensation recognized on stock options (unaudited)			1,075		1,075
Non cash compensation recognized on Restricted Stock (unaudited)	470	1	1,157		1,158
Net income (unaudited)				1,842	1,842
BALANCE, March 31, 2007 (unaudited)	29,632	$ 30	$ 137,794	$ (1,147)	$ 136,677

SEE ACCOMPANYING NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS.

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SMITH MICRO SOFTWARE, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS
(In Thousands)

	Three Months Ended March 31, 2007 (Unaudited)	Three Months Ended March 31, 2006 (Unaudited)
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	$ 1,842	$ 1,812
Adjustments to reconcile net income to net cash provided by operating activities, net of the effect of the acquisitions of PhoTags, Inc. and Ecutel Systems:		
Depreciation and amortization	512	473
Provision for doubtful accounts and other adjustments to accounts receivable	102	145
Provision for slow moving inventory	39	10
Non cash compensation related to stock options & restricted stock	2,233	712
Change in operating accounts, net of effect from acquisition:		
Accounts receivable	877	1,317
Deferred income taxes	1,595	
Inventories	221	(848)
Prepaid expenses and other assets	(325)	55
Accounts payable and accrued liabilities	(470)	39
Net cash provided by operating activities	6,626	3,715
CASH FLOWS FROM INVESTING ACTIVITIES:		
Acquisition of Ecutel Systems, Inc., net of cash received	(8,038)	
Acquisition of PhoTags, Inc., net of cash received	(3,500)	
Capital expenditures	(151)	(137)
Net cash used in investing activities	(11,689)	(137)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Cash received from issuance of common stock, net of offering costs	5,347	
Cash received from exercise of stock options	1,198	1,218
Net cash provided by financing activities	6,545	1,218
NET INCREASE IN CASH AND CASH EQUIVALENTS	1,482	4,796
CASH AND CASH EQUIVALENTS, beginning of period	92,564	21,215

CASH AND CASH EQUIVALENTS, end of period	$ 94,046	$ 26,011

SEE ACCOMPANYING NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS.

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SMITH MICRO SOFTWARE, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS
(In Thousands)

SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION

	For the Three Months Ended March 31,	
	2007	2006
	(Unaudited)	(Unaudited)
Cash paid for income taxes	$	$ 46

SEE ACCOMPANYING NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS.

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SMITH MICRO SOFTWARE, INC.
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

1. NATURE OF OPERATIONS AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Description of Business Smith Micro Software, Inc. and subsidiaries (Smith Micro or the Company) is a developer and marketer of communications and utilities software products and services. Our business model is based primarily upon developing and marketing innovative software solutions for the wireless industry. We sell our products and services to some of the world s leading wireless companies as well as to consumers. Our products are primarily directed to wireless data connectivity, including wireless wide area network (WWAN) for CDMA/GPRS networks, and wireless local area network (WLAN) for Wi-Fi. We also provide software to manage music and other multimedia content, including photo and full motion video, on mobile devices. We are also heavily involved in data compression, primarily focused on a unique way of compression to enable enhanced wireless communications. Our software products target the original equipment manufacturers (OEM) market, particularly wireless service providers and mobile device manufacturers, as well as direct to the consumer. Smith Micro s fundamental product design philosophy is to enhance, simplify, and streamline applications to ensure the best possible consumer experience. Since our inception in 1983, we have shipped over 60 million copies of our various software products.

On February 7, 2007, the Company acquired Ecutel Systems, Inc. (Ecutel), a Delaware Corporation with offices in Herndon, Virginia (see Note 2). Ecutel is a pioneering developer of standards-based, secure enterprise mobility software solutions. The acquisition represents Smith Micro s strategy to broaden the company s product footprint and allow expansion into other high growth wireless security sectors. The integration of IPRoam from Ecutel with Smith Micro s QuickLink Mobile Enterprise connection manager compliments our enterprise product base by providing customers with seamless network roaming in the most secure fashion.

Basis of Presentation The accompanying unaudited interim consolidated financial statements reflect adjustments (consisting of normal recurring adjustments) necessary to present fairly the consolidated financial position of the Company at March 31, 2007, the consolidated results of its operations for the three months ended March 31, 2007 and 2006 and its consolidated cash flows for the three month periods ended March 31, 2007 and 2006. Certain information and footnote disclosures normally included in the consolidated financial statements have been condensed or omitted pursuant to rules and regulations of the Securities and Exchange Commission (SEC), although the Company believes that the disclosures in the unaudited consolidated financial statements are adequate to ensure the information presented is not misleading. These unaudited consolidated financial statements should be read in conjunction with the consolidated financial statements and notes thereto contained in the Company s Annual Report on Form 10-K for the fiscal year ended December 31, 2006. The results of operations of interim periods are not necessarily indicative of future operating results. All intercompany amounts have been eliminated in consolidation.

Cash and Cash Equivalents Cash and cash equivalents generally consist of cash, government securities and money market funds. These securities are all held in one financial institution and are uninsured except for minimum FDIC coverage. As of March 31, 2007 and December 31, 2006, balances totaling approximately $94.5 (unaudited) and $93.1 million, respectively, were uninsured. All have original maturity dates of three months or less.

Accounts Receivable The Company performs ongoing credit evaluations of its customers and generally does not require collateral. The Company maintains reserves for estimated credit losses, and those losses have been within management s estimates. Allowances for product returns are included in other adjustments to accounts receivable on the accompanying consolidated balance sheets. Product returns are estimated based on historical experience and have also been within management s estimates.

Inventories Inventories consist principally of cables, CDs, boxes and manuals and are stated at the lower of cost (determined by the first-in, first-out method) or market. The Company regularly reviews its inventory quantities on hand and records a provision for excess and obsolete inventory based primarily on management s forecast of product demand and production requirements. At March 31, 2007 our inventory balance consisted of approximately $113,000 in assembled products and $509,000 of components.

Equipment and Improvements Equipment and improvements are stated at cost. Depreciation is computed using the straight-line method based on the estimated useful lives of the assets, generally ranging from three to seven years. Leasehold improvements are amortized using the straight-line method over the shorter of the estimated useful life of the asset or the lease term.

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Long Lived Assets The Company accounts for the impairment and disposition of long-lived assets in accordance with Statement of Financial Accounting Standards (SFAS) No. 144, *Accounting for Impairment or Disposal of Long-Lived Assets*. This statement addresses financial accounting and reporting for the impairment of long-lived assets and for the disposal of long-lived assets. In accordance with SFAS No. 144, long-lived assets to be held are reviewed for events or changes in circumstances which indicate that their carrying value may not be recoverable. The Company periodically reviews the carrying value of long-lived assets to determine whether or not an impairment to such value has occurred. The Company has determined that there was no impairment at March 31, 2007.

Goodwill The Company adopted SFAS No. 142, *Goodwill and Other Intangible Assets,* effective January 1, 2002. As a result of the adoption, the Company is no longer required to amortize goodwill. Prior to the adoption of SFAS 142, goodwill was amortized over 7 years. In accordance with SFAS No. 142, the Company reviews the recoverability of the carrying value of goodwill at least annually or whenever events or circumstances indicate a potential impairment. The Company s annual impairment testing date is December 31. Recoverability of goodwill is determined by comparing the fair value of the Company s reporting units to the carrying value of the underlying net assets in the reporting units. If the fair value of a reporting unit is determined to be less than the carrying value of its net assets, goodwill is deemed impaired and an impairment loss is recognized to the extent that the carrying value of goodwill exceeds the difference between the fair value of the reporting unit and the fair value of its other assets and liabilities. At December 31, 2006, we elected to write off all goodwill allocated to the services sector, or $335,000. The consulting portion of our services sector has been de-emphasized and is no longer considered a strategic element of our go forward plan. We determined that we did not have any impairment of goodwill associated with the products sector at December 31, 2006.

The carrying amount of the Company s goodwill was approximately $24.5 million (unaudited) and $15.3 million as of March 31, 2007 and December 31, 2006, respectively.

Other Intangible Assets The following table sets forth the acquired intangible assets by major asset class (in thousands):

	Useful	March 31, 2007			December 31, 2006		
	Life (Years)	Gross	Accumulated Amortization	Net Book Value	Gross	Accumulated Amortization	Net Book Value
Amortizing:							
Purchased and Licensed Technology	3	$ 2,260	(2,260)		$ 2,260	(2,260)	
Capitalized Software	4-5	5,269	(1,919)	3,350	3,849	(1,621)	2,228
Distribution Rights	5	482	(236)	246	482	(208)	274
Customer Lists	5	923	(322)	601	923	(276)	647
Trademarks	10	809	(226)	583	809	(196)	613
Trade Names	7	160	(5)	155			
Customer Agreements	1.5	65	(52)	13	65	(39)	26
Customer Relationships	7	1,230	(29)	1,201			
Totals		$ 11,198	$ (5,049)	$ 6,149	$ 8,388	$ (4,600)	$ 3,788

Aggregate amortization expense on intangible assets was approximately $449,000 and $385,000 for the three months ended March 31, 2007 and 2006, respectively. Expected future amortization expense is as follows: $1,687,000 for the remainder of 2007, $1,602,000 for 2008, $1,009,000 for 2009, $691,000 for 2010, $548,000 for 2011 and $612,000 thereafter. Amortization expense related to intangibles acquired in the Allume acquisition is calculated on a discounted cash flow basis over five years for Capitalized Software, Distribution Rights and Customer Lists and ten years for Trademarks. Amortization is calculated on a straight line basis over five years for Customer Lists. Amortization expense related to intangibles acquired in the PhoTags acquisition is calculated on a discounted cash flow basis over four years for Capitalized Software and 18 months for Customer Agreements. Amortization is calculated on a straight line basis on intangible assets acquired in the Ecutel acquisition, five years for Capitalized Software and seven years for Customer Relationships and Trade Names.

Revenue Recognition The Company currently reports its net revenues under the following operating groups: Multimedia, Connectivity & Security, Compression & Consumer, Mobile Device Management and Other. Within each of these groups software revenue is recognized based on the customer and contract type. The Company recognizes revenue in accordance with the Statement of Position (SOP) 97-2, *Software Revenue Recognition,* as amended, when persuasive evidence of an arrangement exists, delivery has occurred, the price is fixed and determinable, and collectibility is probable. The Company recognizes revenues from sales of its software to Retail and OEM customers or end users as completed products are shipped and title passes, or from royalties generated as authorized customers duplicate the Company s software, if the other requirements of SOP 97-2 are met. If the requirements of SOP 97-2 are not met at the date of shipment, revenue is not recognized until these elements are known or resolved. Returns from Retail and OEM customers are limited to defective goods or goods shipped in error. Historically, OEM customer returns have not been significant. The Company reviews available retail channel information and makes a determination of a return provision for sales made to distributors and retailers based on current channel inventory levels and historical return patterns. Certain sales to distributors or retailers are made on a consignment basis. Revenue for consignment sales are not recognized until sell through to the final customer is established. The Company has a few multiple elements agreements for which it has contracted to provide a perpetual license for use of proprietary software, to provide non-recurring engineering, and in some cases to provide software maintenance (post contract support). For multiple element agreements, vendor specific objective evidence for all contract elements is reviewed and the timing of the individual element revenue streams is determined and recognized consistent with SOP 97-2. Sales directly to end-users are recognized upon delivery. End users have a thirty day right of return, but such returns are reasonably estimable and have historically been immaterial. The Company also provides technical support to its customers. Such costs have historically been insignificant.

Sales Incentives Pursuant to the consensus of EITF 01-09, *Accounting for Consideration Given by a Vendor to a Customer (Including a Reseller of the Vendor s Product),* effective January 1, 2002, the cost of sales incentives the Company offers without charge to customers that can be used in, or that are exercisable by a customer as a result of, a single exchange transaction is accounted for as a reduction of revenue. We track incentives by program and use historical redemption rates to estimate the cost of customer incentives. Total rebates were $139,000 and $70,000 for the three months ended March 31, 2007 and 2006, respectively

Software Development Costs Development costs incurred in the research and development of new software products and enhancements to existing software products are expensed as incurred until technological feasibility has been established. The Company considers technological feasibility to be established when all planning, designing, coding and testing has been completed according to design specifications. After technological feasibility is established, any additional costs are capitalized. Through March 31, 2007, software has been substantially completed concurrently with the establishment of technological feasibility; and, accordingly, no costs have been capitalized to date.

Income Taxes The Company accounts for income taxes under SFAS No. 109, *Accounting for Income Taxes*. This statement requires the recognition of deferred tax assets and liabilities for the future consequences of events that have been recognized in the Company s financial statements or tax returns. The measurement of the deferred items is based on enacted tax laws. In the event the future consequences of differences between financial reporting bases and the tax bases of the Company s assets and liabilities result in a deferred tax asset, SFAS No. 109 requires an evaluation of the probability of being able to realize the future benefits indicated by such asset. A valuation allowance related to a deferred tax asset is recorded when it is more likely than not that some portion or all of the deferred tax asset will not be realized. The Company reversed all of its valuation allowance on its deferred tax assets during the year ended 2006 as a result of the Company s improving financial performance and projected income in future years. In addition, effective January 1, 2007, the Company adopted FIN 48, *Accounting for Uncertainty in Income Taxes-an interpretation of FASB Statement No. 109*. Based on our evaluation, we have concluded that there are no significant uncertain tax positions requiring recognition in our financial statements. (See Note 4).

Net Income per Share Pursuant to SFAS No. 128, *Earnings per Share,* the Company is required to provide dual presentation of basic and diluted earnings per share (EPS). Basic EPS amounts are based upon the weighted average number of common shares outstanding. Diluted EPS amounts are based upon the weighted average number of common and potential common shares outstanding. Potential common shares for diluted EPS include stock options, using the treasury stock method, of 1,633,000 and 1,981,000 for the three months ended March 31, 2007 and March 31, 2006, respectively. Certain potential common shares from exercise of options have been excluded from the computation of diluted earnings per share due to their exercise price being greater than the Company s weighted-average stock price for the period. For the three months ended March 31, 2007 and 2006, the number of shares excluded were 820,000 and 9,000, respectively.

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Fulfillment Services The Company currently holds consigned inventory for a customer, which is used to fulfill internet orders. As the Company does not hold title to the inventory, it is not recorded in the accompanying unaudited condensed consolidated balance sheet. In addition, the Company receives cash for internet fulfillment orders which is paid out to the fulfillment customer on a monthly basis. Such cash and the related payable are recorded on a net basis as the amounts are held for the benefit of this fulfillment customer. Revenue is recognized for fulfillment services as services are performed.

Segment Information In early 2007, we completed two acquisitions. The acquisition of Ecutel Systems, Inc. in February, and the asset purchase of Insignia Solutions in April. Based on the new acquisitions and the broadening of our OEM product offering, we will begin breaking out our revenues consistent with our new internal operating perspective. We currently sell products in the following product categories: Multimedia, which includes music, photo and video library management; Connectivity and Security, which includes our connection manager solutions for both the OEM and Enterprise channels; Compression and Consumer, which includes OEM and retail sales of our compression and broad consumer-based software; Mobile Device Management, which includes our firmware over the air upgrade software branded under the Insignia name, and finally, other revenue , which includes miscellaneous legacy accounts that are no longer strategic to the company.

The Company does not separately allocate operating expenses to these segments, nor does it allocate specific assets to these segments. Therefore, segment information reported includes only revenues.

The following table shows the net revenues generated by each segment:

	Three Months Ended March 31,	
	2007	2006
	(in thousands)	
Multimedia	$ 8,486	$ 3,873
Connectivity & Security	6,118	3,187
Consumer & Compression	2,772	2,582
Mobile Device Management		
Corporate/Other	291	243
Total Revenues	17,667	9,885
Cost of Revenues	5,679	3,299
Gross Profit	$ 11,988	$ 6,586

Sales to individual customers and their affiliates which amounted to more than 10% of the Company s net revenues for the three months ended March 31, 2007 and 2006, respectively, included one OEM customer at 73.9% in 2007 and one OEM customer at 71.0% in 2006.

Use of Estimates The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management 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 financial statements and the reported amounts of revenues and expenses during the reporting periods. Actual results could materially differ from those estimates.

Comprehensive Income Comprehensive income, as defined, includes all changes in equity (net assets) during a period from non-owner sources. For each of the periods ended March 31, 2007 and 2006, there was no difference between net income, as reported, and comprehensive income.

Significant Concentrations For the quarter ending March 31, 2007, one customer made up more than 10% of revenues and 47% of accounts receivable, and three suppliers, each with more than 10% of inventory purchases, totaled 23% of accounts payable.

New Accounting Pronouncements In February 2006, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Issues (SFAS) No. 155, *Accounting for Certain Hybrid Financial Instruments*, which amends SFAS No. 133, *Accounting for Derivatives Instruments and Hedging Activities* and SFAS No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities*. SFAS 155 amends SFAS No. 133 to narrow the scope exception for interest-only and principal-only strips on debt instruments to include only such strips representing rights to receive a specified portion of the contractual interest or principle cash flows. SFAS 155 also amends SFAS No. 140 to allow qualifying special-purpose entities to hold a passive derivative financial instrument pertaining to beneficial interests that itself is a derivative instrument. This new Standard did not have a material impact on the Company s financial position, results of operations, or cash flows.

In March 2006, the FASB issued SFAS No. 156, *Accounting for Servicing of Financial Assets* (SFAS 156), which provides an approach to simplify efforts to obtain hedge-like (offset) accounting. This Statement amends FASB Statement 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, with respect to the accounting for separately recognized servicing assets and servicing liabilities. The Statement (1) requires an entity to recognize a servicing asset or servicing liability each time it undertakes an obligation to service a financial asset by entering into a servicing contract in certain situations; (2) requires that a separately recognized servicing asset or servicing liability be initially measured at fair value, if practicable; (3) permits an entity to choose either the amortization method or the fair value method for subsequent measurement for each class of separately recognized servicing assets or servicing liabilities; (4) permits at initial adoption a one-time reclassification of available-for-sale securities to trading securities by an entity with recognized servicing rights, provided the securities reclassified offset the entity s exposure to changes in the fair value of the servicing assets or liabilities; and (5) requires separate presentation of servicing assets and servicing liabilities subsequently measured at fair value in the balance sheet and additional disclosures for all separately recognized servicing assets and servicing liabilities. SFAS 156 is effective for all separately recognized servicing assets and liabilities as of the beginning of an entity s fiscal year that begins after September 15, 2006, with earlier adoption permitted in certain circumstances. The Statement also describes the manner in which it should be initially applied. The adoption of SFAS 156 did not have a material impact on the Company s financial position, results of operations or cash flows.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements* (SFAS 157), which defines the fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements. This statement is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. Early adoption is encouraged, provided that we have not yet issued financial statements for that fiscal year, including any financial statements for an interim period within that fiscal year. The Company is currently in the process of evaluating the impact SFAS 157 may have on its results of operations and financial position.

In September 2006, the FASB issued SFAS No. 158, *Employer s Accounting for Defined Benefit Pension and Other Post Retirement Plans*. SFAS No. 158 requires employers to recognize in its statement of financial position an asset or liability based on the retirement plan s over or under funded status. SFAS No. 158 is effective for fiscal years ending after December 15, 2006. The adoption of SFAS 158 did not have a material impact on the Company s results of operations and financial position.

In September 2006, the United States Securities and Exchange Commission (SEC) issued Staff Accounting Bulletin No. 108, *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements* (SAB 108). This SAB provides guidance on the consideration of the effects of prior year misstatements in quantifying current year misstatements for the purpose of a materiality assessment. SAB 108 establishes an approach that requires quantification of financial statement errors based on the effects of each of the company s balance sheets and statement of operations and the related financial statement disclosures. The SAB permits existing public companies to record the cumulative effect of initially applying this approach in the first year ending after November 15, 2006 by recording the necessary correcting adjustments to the carrying values of assets and liabilities as of the beginning of that year with the offsetting adjustment recorded to the opening balance of retained earnings. Additionally, the use of the cumulative effect transition method requires detailed disclosure of the nature and amount of each individual error being corrected through the cumulative adjustment and how and when it arose. The adoption of SAB 108 did not have a material impact on the Company s results of operations and financial position.

In October 2006, the Emerging Issues Task Force (EITF) issued EITF 06-3, *How Taxes Collected from Customers and Remitted to Governmental Authorities Should Be Presented in the Income Statement (That is, Gross versus Net Presentation)* to clarify diversity in practice on the presentation of different types of taxes in the financial statements. The Task Force concluded that, for taxes within the scope of the issue, a company may adopt a policy of presenting taxes either gross within revenue or net. That is, it may include charges to customers for taxes within revenues and the charge for the taxes from the taxing authority within cost of sales, or, alternatively, it may net the charge to the customer and the charge from the taxing authority. If taxes subject to EITF 06-3 are significant, a company is required to disclose its accounting policy for presenting taxes and the amounts of such taxes that are recognized on a gross basis. The guidance in this consensus is effective for the first interim reporting period beginning after December 15, 2006 (the first quarter of our fiscal year 2007). The adoption of EITF 06-3 did not have a material impact on the Company s results of operations, financial position or cash flow.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*. SFAS No. 159 permits entities to choose to measure at fair value many financial instruments and certain other items that are not currently required to be measured at fair value. Subsequent changes in fair value for designated items will be required to be reported in earnings in the current period. SFAS No. 159 also establishes presentation and disclosure requirements for similar types of assets and liabilities measured at fair value. SFAS No. 159 is effective for fiscal years beginning after November 15, 2007. The Company is currently assessing the effect of implementing this guidance, which directly depends on the nature and extent of eligible items elected to be measured at fair value, upon initial application of the standard on January 1, 2008.

2. ACQUISITION OF ECUTEL SYSTEMS, INC.

On February 9, 2007, the Company, TEL Acquisition Corp., a wholly-owned subsidiary of the Company, Ecutel Systems, Inc., John J. McDonnell, Jr. and the Principal Stockholders of Ecutel consummated the merger of Ecutel with and into TEL Acquisition Co. pursuant to the terms of that certain Agreement and Plan of Merger dated as of January 31, 2007.

In connection with the Merger, all outstanding shares of capital stock of Ecutel were converted into the right to receive a portion of the merger consideration. The aggregate merger consideration paid by the Company in connection with the Merger was $8,000,000 in cash, of which $1,000,000 is being withheld as security for satisfaction of certain indemnification obligations pursuant to the terms of the Merger Agreement. The consideration for and the other terms and conditions of the Merger were determined by arms-length negotiations between the Company, Ecutel and the Principal Stockholders of Ecutel.

The Company estimates that $101,000 in direct costs (legal and professional services) were incurred to close the transaction.

A copy of the Merger Agreement has been filed under Form 8-K with the Securities and Exchange Commission.

The results of operations of the business acquired have been included in the Company s consolidated financial statements from the date of acquisition. Amortization related to the acquisition was calculated based on an independent valuation for certain identifiable intangibles acquired which will be amortized over periods ranging from five to seven years.

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