

SMITH MICRO SOFTWARE INC

Form 10-Q

November 03, 2011

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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**  
**WASHINGTON, D.C. 20549**

**FORM 10-Q**

(Mark One)

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

For the quarterly period ended September 30, 2011

OR

☐ **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)

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**DELAWARE**  
(State or other jurisdiction of  
incorporation or organization)

**33-0029027**  
(I.R.S. Employer  
Identification No.)

**51 COLUMBIA**

**ALISO VIEJO, CA 92656**

(Address of principal executive offices, including zip code)

**(949) 362-5800**

(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 ☒ No ☐

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes ☒ No ☐

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

|                                                                                              |                                                       |
|----------------------------------------------------------------------------------------------|-------------------------------------------------------|
| Large accelerated filer <input type="checkbox"/>                                             | Accelerated filer <input checked="" type="checkbox"/> |
| Non-accelerated filer <input type="checkbox"/> (Do not check if a smaller reporting company) | Small reporting company <input type="checkbox"/>      |

Indicate by check mark whether the registrant is a shell company (as defined in Exchange Act Rule 12b-2). Yes ☐ No ☒

As of October 28, 2011 there were 35,763,066 shares of common stock outstanding.

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**SMITH MICRO SOFTWARE, INC.**

**QUARTERLY REPORT ON FORM 10-Q**

**September 30, 2011**

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**Table of Contents****PART I. FINANCIAL INFORMATION****Item 1. Financial Statements****SMITH MICRO SOFTWARE, INC.****CONSOLIDATED BALANCE SHEETS****(in thousands, except share and par value data)**

|                                                                                                                                                                                            | September 30,<br>2011<br>(unaudited) | December 31,<br>2010<br>(audited) |
|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|--------------------------------------|-----------------------------------|
| <b>Assets</b>                                                                                                                                                                              |                                      |                                   |
| Current assets:                                                                                                                                                                            |                                      |                                   |
| Cash and cash equivalents                                                                                                                                                                  | \$ 20,079                            | \$ 17,856                         |
| Short-term investments                                                                                                                                                                     | 33,991                               | 54,694                            |
| Accounts receivable, net of allowances for doubtful accounts and other adjustments of \$573 (2011) and \$855 (2010)                                                                        | 9,036                                | 29,812                            |
| Income tax receivable                                                                                                                                                                      | 8,050                                | 2,872                             |
| Inventories, net of reserves for excess and obsolete inventory of \$380 (2011) and \$558 (2010)                                                                                            | 321                                  | 370                               |
| Prepaid expenses and other current assets                                                                                                                                                  | 1,664                                | 1,167                             |
| Deferred tax asset                                                                                                                                                                         | 97                                   | 2,565                             |
| Total current assets                                                                                                                                                                       | 73,238                               | 109,336                           |
| Equipment and improvements, net                                                                                                                                                            | 16,323                               | 11,623                            |
| Goodwill                                                                                                                                                                                   |                                      | 94,231                            |
| Intangible assets, net                                                                                                                                                                     |                                      | 19,459                            |
| Other assets                                                                                                                                                                               | 221                                  | 243                               |
| Total assets                                                                                                                                                                               | \$ 89,782                            | \$ 234,892                        |
| <b>Liabilities and Stockholders' Equity</b>                                                                                                                                                |                                      |                                   |
| Current liabilities:                                                                                                                                                                       |                                      |                                   |
| Accounts payable                                                                                                                                                                           | \$ 4,669                             | \$ 4,592                          |
| Accrued liabilities                                                                                                                                                                        | 7,527                                | 8,444                             |
| Deferred revenue                                                                                                                                                                           | 423                                  | 1,667                             |
| Total current liabilities                                                                                                                                                                  | 12,619                               | 14,703                            |
| Non-current liabilities:                                                                                                                                                                   |                                      |                                   |
| Long-term liabilities                                                                                                                                                                      | 3,641                                | 197                               |
| Deferred tax liability                                                                                                                                                                     | 100                                  | 1,727                             |
| Total non-current liabilities                                                                                                                                                              | 3,741                                | 1,924                             |
| 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; 35,763,252 and 34,971,108 shares issued and outstanding at September 30, 2011 and December 31, 2010, respectively | 36                                   | 35                                |
| Additional paid-in capital                                                                                                                                                                 | 206,969                              | 201,702                           |
| Accumulated other comprehensive loss                                                                                                                                                       | (40)                                 | (10)                              |
| Accumulated earnings (deficit)                                                                                                                                                             | (133,543)                            | 16,538                            |

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|                                            |           |            |
|--------------------------------------------|-----------|------------|
| Total stockholders' equity                 | 73,422    | 218,265    |
| Total liabilities and stockholders' equity | \$ 89,782 | \$ 234,892 |

See accompanying notes to the consolidated financial statements.

**Table of Contents****SMITH MICRO SOFTWARE, INC.****CONSOLIDATED STATEMENTS OF OPERATIONS****(in thousands, except per share data)**

|                                          | Three Months Ended<br>September 30, |             | Nine Months Ended<br>September 30, |             |
|------------------------------------------|-------------------------------------|-------------|------------------------------------|-------------|
|                                          | 2011                                | 2010        | 2011                               | 2010        |
|                                          | (unaudited)                         | (unaudited) | (unaudited)                        | (unaudited) |
| Revenues                                 | \$ 12,632                           | \$ 34,008   | \$ 46,528                          | \$ 95,227   |
| Cost of revenues                         | 3,699                               | 3,771       | 11,035                             | 11,468      |
| Gross profit                             | 8,933                               | 30,237      | 35,493                             | 83,759      |
| Operating expenses:                      |                                     |             |                                    |             |
| Selling and marketing                    | 6,456                               | 7,344       | 21,915                             | 22,032      |
| Research and development                 | 10,696                              | 10,972      | 33,692                             | 31,195      |
| General and administrative               | 5,876                               | 6,059       | 20,039                             | 18,082      |
| Restructuring expenses                   | 984                                 |             | 984                                |             |
| Goodwill and long-lived asset impairment | 112,904                             |             | 112,904                            |             |
| Total operating expenses                 | 136,916                             | 24,375      | 189,534                            | 71,309      |
| Operating income (loss)                  | (127,983)                           | 5,862       | (154,041)                          | 12,450      |
| Interest and other income                | 13                                  | 82          | 98                                 | 115         |
| Income (loss) before taxes               | (127,970)                           | 5,944       | (153,943)                          | 12,565      |
| Income tax expense (benefit)             | 6,511                               | 2,850       | (3,862)                            | 5,994       |
| Net income (loss)                        | \$ (134,481)                        | \$ 3,094    | \$ (150,081)                       | \$ 6,571    |
| Net income (loss) per share:             |                                     |             |                                    |             |
| Basic                                    | \$ (3.76)                           | \$ 0.09     | \$ (4.22)                          | \$ 0.19     |
| Diluted                                  | \$ (3.76)                           | \$ 0.09     | \$ (4.22)                          | \$ 0.19     |
| Weighted average shares outstanding:     |                                     |             |                                    |             |
| Basic                                    | 35,728                              | 34,274      | 35,590                             | 34,091      |
| Diluted                                  | 35,728                              | 34,736      | 35,590                             | 34,560      |

See accompanying notes to the consolidated financial statements.

**Table of Contents****SMITH MICRO SOFTWARE, INC.****CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY****(in thousands)**

|                                                               | Common stock  |              | Additional<br>paid-in<br>capital | Accumulated<br>other<br>comprehensive<br>loss | Accumulated<br>earnings<br>(deficit) | Total             |
|---------------------------------------------------------------|---------------|--------------|----------------------------------|-----------------------------------------------|--------------------------------------|-------------------|
|                                                               | Shares        | Amount       |                                  |                                               |                                      |                   |
| <b>BALANCE, December 31, 2010</b>                             | <b>34,971</b> | <b>\$ 35</b> | <b>\$ 201,702</b>                | <b>\$ (10)</b>                                | <b>\$ 16,538</b>                     | <b>\$ 218,265</b> |
| Exercise of common stock options                              | 6             |              | 12                               |                                               |                                      | 12                |
| Non cash compensation recognized on stock options<br>and ESPP |               |              | 956                              |                                               |                                      | 956               |
| Restricted stock grants, net of cancellations                 | 719           | 1            | 4,174                            |                                               |                                      | 4,175             |
| Cancellation of shares for payment of withholding tax         | (29)          |              | (288)                            |                                               |                                      | (288)             |
| Employee stock purchase plan (ESPP)                           | 96            |              | 413                              |                                               |                                      | 413               |
| Other comprehensive income (loss):                            |               |              |                                  |                                               |                                      |                   |
| Unrealized loss on short-term investments                     |               |              |                                  | (30)                                          |                                      | (30)              |
| Net loss                                                      |               |              |                                  |                                               | (150,081)                            | (150,081)         |
| Total comprehensive loss                                      |               |              |                                  |                                               |                                      | (150,111)         |
| <b>BALANCE, September 30, 2011 (unaudited)</b>                | <b>35,763</b> | <b>\$ 36</b> | <b>\$ 206,969</b>                | <b>\$ (40)</b>                                | <b>\$ (133,543)</b>                  | <b>\$ 73,422</b>  |

See accompanying notes to the unaudited consolidated financial statements.

**Table of Contents****SMITH MICRO SOFTWARE, INC.****CONSOLIDATED STATEMENTS OF CASH FLOWS****(in thousands)**

|                                                                                                                                       | Nine Months Ended September 30,<br>2011<br>(unaudited) | 2010<br>(unaudited) |
|---------------------------------------------------------------------------------------------------------------------------------------|--------------------------------------------------------|---------------------|
| <b>Operating activities:</b>                                                                                                          |                                                        |                     |
| Net income (loss)                                                                                                                     | \$ (150,081)                                           | \$ 6,571            |
| Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities, net of the effect of acquisitions: |                                                        |                     |
| Depreciation and amortization                                                                                                         | 9,078                                                  | 8,911               |
| Goodwill and long-lived asset impairment                                                                                              | 112,904                                                |                     |
| Loss on disposal of fixed assets                                                                                                      | 108                                                    |                     |
| Lease incentives                                                                                                                      | 2,223                                                  |                     |
| Provision for doubtful accounts and other adjustments to accounts receivable                                                          | 372                                                    | 908                 |
| Provision for excess and obsolete inventory                                                                                           | 121                                                    | 167                 |
| Excess tax benefits from stock-based compensation                                                                                     |                                                        | (648)               |
| Non-cash compensation related to stock options and restricted stock                                                                   | 5,131                                                  | 7,012               |
| Change in operating accounts, net of effect from acquisitions:                                                                        |                                                        |                     |
| Accounts receivable                                                                                                                   | 20,404                                                 | (9,038)             |
| Income tax receivable                                                                                                                 | (5,178)                                                |                     |
| Deferred taxes                                                                                                                        | 841                                                    | 4                   |
| Inventories                                                                                                                           | (72)                                                   | (143)               |
| Prepaid expenses and other assets                                                                                                     | (475)                                                  | 373                 |
| Accounts payable and accrued liabilities                                                                                              | (1,150)                                                | 1,301               |
| Net cash provided by (used in) operating activities                                                                                   | (5,774)                                                | 15,418              |
| <b>Investing activities:</b>                                                                                                          |                                                        |                     |
| Acquisitions, net of cash received                                                                                                    |                                                        | (532)               |
| Capital expenditures                                                                                                                  | (13,100)                                               | (4,210)             |
| Sale (purchase) of short-term investments                                                                                             | 20,673                                                 | (13,948)            |
| Net cash provided by (used in) investing activities                                                                                   | 7,573                                                  | (18,690)            |
| <b>Financing activities:</b>                                                                                                          |                                                        |                     |
| Excess tax benefits from stock-based compensation                                                                                     |                                                        | 648                 |
| Cash received from stock sale for employee stock purchase plan                                                                        | 412                                                    |                     |
| Cash received from exercise of stock options                                                                                          | 12                                                     | 349                 |
| Net cash provided by financing activities                                                                                             | 424                                                    | 997                 |
| Net increase (decrease) in cash and cash equivalents                                                                                  | 2,223                                                  | (2,275)             |
| Cash and cash equivalents, beginning of period                                                                                        | 17,856                                                 | 14,577              |
| Cash and cash equivalents, end of period                                                                                              | \$ 20,079                                              | \$ 12,302           |
| <b>Supplemental disclosures of cash flow information:</b>                                                                             |                                                        |                     |
| Cash paid for income taxes                                                                                                            | \$ 519                                                 | \$ 3,389            |

See accompanying notes to the consolidated financial statements.



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**SMITH MICRO SOFTWARE, INC.**

**Notes to the Consolidated Financial Statements**

**1. The Company**

Smith Micro Software, Inc. ( we, us, our, Smith Micro, or the Company ) designs, develops and markets software solutions primarily for the wireless industry. Our portfolio of products and services spans connectivity management and communications solutions that simplify, secure and enhance the mobile experience. The Company's connectivity clients are installed on millions of devices across 3G, 4G and Wi-Fi networks. Our QuickLink® product family has been expanded to include the Experience Manager and Mobile Network Director solutions for optimizing network resources and increasing average-revenue-per-user ( ARPU ) for wireless operators. Our mobile communications solutions, which include Push-To-Talk, Visual Voicemail, Voice-to-Text, and Vidio , are used by leading wireless operators around the world. Our device management products are sold to original equipment manufacturers ( OEM ), device manufacturers and enterprise businesses to reduce the cost of ownership and enable secure connectivity for mobile devices. The company also sells Productivity and Graphics solutions directly to consumers and through reseller channels.

**2. Basis of Presentation**

The accompanying interim consolidated balance sheet and statement of stockholders' equity as of September 30, 2011, and the related statements of operations for the three and nine months ended September 30, 2011 and 2010 and the related cash flows for the nine months ended September 30, 2011 and 2010 are unaudited. The unaudited consolidated financial statements have been prepared according to the rules and regulations of the Securities and Exchange Commission ( SEC ) and, therefore, certain information and disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States have been omitted.

In the opinion of management, the accompanying unaudited consolidated financial statements for the periods presented reflect all adjustments, which are normal and recurring, necessary to fairly state the financial position, results of operations and cash flows. These unaudited consolidated financial statements should be read in conjunction with the audited financial statements included in our Annual Report on Form 10-K for the fiscal year ended December 31, 2010 filed with the SEC on February 25, 2011.

Intercompany balances and transactions have been eliminated in consolidation.

Operating results for the three and nine months ended September 30, 2011 are not necessarily indicative of the results that may be expected for any other interim period or for the fiscal year ending December 31, 2011.

**3. Net Income (Loss) Per Share**

The Company calculates earnings per share ( EPS ) as required by Financial Accounting Standards Board ( FASB ) Accounting Standards Codification ( ASC ) Topic No. 260, Earnings Per Share. Basic EPS is calculated by dividing the net income available to common stockholders by the weighted average number of common shares outstanding for the period, excluding common stock equivalents. Diluted EPS is computed by dividing the net income available to common stockholders by the weighted average number of common shares outstanding for the period plus the weighted average number of dilutive common stock equivalents outstanding for the period determined using the treasury-stock method. For periods with a net loss, the dilutive common stock equivalents are excluded from the diluted EPS calculation. For purposes of this calculation, common stock subject to repurchase by the Company and options are considered to be common stock equivalents and are only included in the calculation of diluted earnings per share when their effect is dilutive.

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|                                                                                                   | Three Months Ended September 30,                    |          | Nine Months Ended September 30, |          |
|---------------------------------------------------------------------------------------------------|-----------------------------------------------------|----------|---------------------------------|----------|
|                                                                                                   | 2011                                                | 2010     | 2011                            | 2010     |
|                                                                                                   | (unaudited, in thousands, except per share amounts) |          |                                 |          |
| <b>Numerator:</b>                                                                                 |                                                     |          |                                 |          |
| Net income (loss) available to common stockholders                                                | \$ (134,481)                                        | \$ 3,094 | \$ (150,081)                    | \$ 6,571 |
| <b>Denominator:</b>                                                                               |                                                     |          |                                 |          |
| Weighted average shares outstanding - basic                                                       | 35,728                                              | 34,274   | 35,590                          | 34,091   |
| Potential common shares - options (treasury stock method)                                         |                                                     | 462      |                                 | 469      |
| Weighted average shares outstanding - diluted                                                     | 35,728                                              | 34,736   | 35,590                          | 34,560   |
| Shares excluded (anti-dilutive)                                                                   | 56                                                  |          | 231                             |          |
| Shares excluded due to an exercise price greater than weighted average stock price for the period | 2,237                                               | 2,410    | 1,738                           | 2,410    |
| <b>Net income (loss) per common share:</b>                                                        |                                                     |          |                                 |          |
| Basic                                                                                             | \$ (3.76)                                           | \$ 0.09  | \$ (4.22)                       | \$ 0.19  |
| Diluted                                                                                           | \$ (3.76)                                           | \$ 0.09  | \$ (4.22)                       | \$ 0.19  |

**4. Stock-Based Compensation***Stock Plans*

On July 28, 2005, our Shareholders approved the 2005 Stock Option / Stock Issuance Plan ( 2005 Plan ). The 2005 Plan, which became effective the same date, replaced the 1995 Stock Option / Stock Issuance Plan ( 1995 Plan ), which expired on May 24, 2005. All outstanding options under the 1995 Plan remained outstanding, but no further grants will be made under that Plan.

The 2005 Plan provides for the issuance of non-qualified or incentive stock options and restricted stock to employees, non-employee members of the board and consultants. The exercise price per share for options is not to be less than the fair market value per share of the Company's common stock on the date of grant. The Board of Directors has the discretion to determine the vesting schedule. Options may be exercisable immediately or in installments, but generally vest over a four-year period from the date of grant. In the event the holder ceases to be employed by the Company, all unvested options terminate and all vested options may be exercised within a period following termination. In general, options expire ten years from the date of grant. Restricted stock is valued using the closing stock price on the date of the grant. The total value is expensed over the vesting period of 12 to 48 months. The maximum number of shares of the Company's common stock that were available for issuance over the term of the original 2005 Plan could not exceed 5,000,000 shares, plus that number of additional shares equal to 2.5% of the number of shares of common stock outstanding on the last trading day of the calendar year commencing with calendar year 2006 (but not in excess of 750,000 shares). On October 11, 2007, our shareholders voted to approve an amendment to the 2005 Plan to increase the maximum number of shares of common stock that may be issued under the 2005 Plan from 5,000,000 shares (plus an annual increase) to 7,000,000 shares (plus an annual increase).

*Employee Stock Purchase Plan*

The Company has a shareholder approved employee stock purchase plan ( ESPP ), under which substantially all employees may purchase the Company's common stock through payroll deductions at a price equal to 85% of the lower of the fair market values of the stock as of the beginning and end of six-month offering periods. An employee's payroll deductions under the ESPP are limited to 10% of the employee's compensation and employees may not purchase more than the lesser of \$25,000 of stock, or 1,000 shares, for any calendar year. Additionally, no more than 1,000,000 shares may be purchased under the plan.

*Stock Compensation Expense*

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The Company accounts for all stock-based payment awards made to employees and directors based on their fair values and recognized as compensation expense over the vesting period using the straight-line method over the requisite service period for each award as required by FASB ASC Topic No. 718, Compensation-Stock Compensation.

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Stock-based non-cash compensation expenses related to stock options, restricted stock grants and the employee stock purchase plan were recorded in the financial statements as follows (in thousands):

|                                                  | Three Months Ended September 30, |                 | Nine Months Ended September 30, |                 |
|--------------------------------------------------|----------------------------------|-----------------|---------------------------------|-----------------|
|                                                  | 2011                             | 2010            | 2011                            | 2010            |
|                                                  | (unaudited)                      |                 | (unaudited)                     |                 |
| Cost of revenues                                 | \$ 5                             | \$ 23           | \$ 27                           | \$ 76           |
| Selling and marketing                            | 336                              | 627             | 1,431                           | 1,890           |
| Research and development                         | 153                              | 615             | 1,003                           | 1,817           |
| General and administrative                       | 661                              | 1,079           | 2,670                           | 3,229           |
| <b>Total non-cash stock compensation expense</b> | <b>\$ 1,155</b>                  | <b>\$ 2,344</b> | <b>\$ 5,131</b>                 | <b>\$ 7,012</b> |

Total stock-based compensation for each quarter includes cash payment of income taxes related to grants of restricted stock in the amount of \$0.1 million and \$0.4 million in the three months ended September 30, 2011 and 2010, respectively. The cash payment of income taxes related to grants of restricted stock totaled \$1.4 million and \$1.5 million for the nine months ended September 30, 2011 and 2010, respectively.

### Valuation of ESPP

The Company's first offering period began October 1, 2010 and ended March 31, 2011 and a total of 43,335 shares were purchased on March 31, 2011 with a fair value of \$3.98 per share. The Company's latest six-month offering period began on April 1, 2011 and ended on September 30, 2011 and a total of 52,425 shares were purchased in the offering period with a fair value of \$3.61 per share. The fair values are estimated at the beginning of each offering period using a Black-Scholes valuation model that uses the assumptions noted in the following table. The risk-free rate is based on the U.S. treasury yield curve in effect at the time of grant. Expected volatility was based on the historical volatility on the day of grant.

| Assumptions                            | Offering Period Ended<br>March 31, 2011 | Offering Period Ended<br>September 30,<br>2011 |
|----------------------------------------|-----------------------------------------|------------------------------------------------|
| Risk-free interest rate (average)      | 0.18%                                   | 0.12%                                          |
| Expected dividend yield                |                                         |                                                |
| Weighted average expected life (years) | 0.5                                     | 0.5                                            |
| Volatility (average)                   | 72.0%                                   | 72.0%                                          |

### Stock Options

There were no stock options granted during the three months ended September 30, 2011 and 2010. There were stock options to purchase 25,000 shares granted during the nine months ended September 30, 2011 with a weighted average grant-date fair value of \$1.16. There were stock options to purchase 20,000 shares granted during the nine months ended September 30, 2010 with a weighted average grant-date fair value of \$2.97. The assumptions used to compute the stock-based compensation costs for the stock options granted during the nine months ended September 30, 2011 and 2010, using the Black-Scholes option pricing model, were as follows:

| Assumptions                            | Nine Months Ended September 30, |       |
|----------------------------------------|---------------------------------|-------|
|                                        | 2011                            | 2010  |
|                                        | (unaudited)                     |       |
| Risk-free interest rate (average)      | 0.19%                           | 0.32% |
| Expected dividend yield                |                                 |       |
| Weighted average expected life (years) | 1.0                             | 1.0   |
| Volatility (average)                   | 73.0%                           | 72.0% |
| Forfeiture rate                        |                                 |       |



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A summary of the Company's stock options outstanding under the 2005 Plan as of September 30, 2011, and the activity during the nine months then ended, are as follows:

|                                                  | Shares<br>(in thousands except per share amounts) | Weighted Ave.<br>Exercise<br>Price | Aggregate<br>Intrinsic Value |
|--------------------------------------------------|---------------------------------------------------|------------------------------------|------------------------------|
| Outstanding as of December 31, 2010              | 2,706                                             | \$ 11.69                           |                              |
| Granted (unaudited)                              | 25                                                | \$ 4.07                            |                              |
| Exercised (unaudited)                            | (7)                                               | \$ 1.84                            |                              |
| Cancelled (unaudited)                            | (331)                                             | \$ 14.07                           |                              |
| Outstanding as of September 30, 2011 (unaudited) | 2,393                                             | \$ 11.31                           | \$                           |
| Exercisable as of September 30, 2011 (unaudited) | 2,388                                             | \$ 11.31                           | \$                           |

During the nine months ended September 30, 2011, options to acquire 6,688 shares were exercised with an intrinsic value of zero, resulting in cash proceeds to the Company of \$12,000. As of September 30, 2011, all compensation costs related to stock options granted under the Plan have been recognized. At September 30, 2011, there were 1.8 million shares available for future grants under the 2005 Stock Issuance / Stock Option Plan.

Additional information regarding options outstanding as of September 30, 2011 is as follows:

| Range of<br>exercise<br>prices | Options outstanding                     |                                                              |                                          | Options exercisable                     |                                          |
|--------------------------------|-----------------------------------------|--------------------------------------------------------------|------------------------------------------|-----------------------------------------|------------------------------------------|
|                                | Number<br>outstanding<br>(in thousands) | Weighted average<br>remaining<br>contractual<br>life (years) | Weighted<br>average<br>exercise<br>price | Number<br>exercisable<br>(in thousands) | Weighted<br>average<br>exercise<br>price |
| \$0.24 - \$4.00                | 157                                     | 2.5                                                          | \$ 1.62                                  | 157                                     | \$ 1.62                                  |
| \$4.01 - \$6.00                | 470                                     | 4.0                                                          | \$ 4.93                                  | 470                                     | \$ 4.93                                  |
| \$6.01 - \$12.00               | 179                                     | 6.0                                                          | \$ 8.81                                  | 174                                     | \$ 8.85                                  |
| \$12.01 - \$14.00              | 785                                     | 5.4                                                          | \$ 12.65                                 | 785                                     | \$ 12.65                                 |
| \$14.01 - \$16.00              | 515                                     | 5.5                                                          | \$ 15.17                                 | 515                                     | \$ 15.17                                 |
| \$16.01 - \$19.00              | 287                                     | 5.6                                                          | \$ 17.95                                 | 287                                     | \$ 17.95                                 |
|                                | 2,393                                   | 5.0                                                          | \$ 11.31                                 | 2,388                                   | \$ 11.31                                 |

*Restricted Stock Awards*

Grants of restricted stock are valued using the closing stock price on the date of grant. In the nine months ended September 30, 2011, a total of 0.9 million shares of restricted stock, with a total value of \$8.4 million, were granted to key officers and employees of the Company. This cost will be amortized over a period of 48 months. In addition, 70,000 shares of restricted stock, with a total value of \$0.4 million, were granted to members of the Board of Directors. This cost will be amortized over a period of 12 months.

A summary of the Company's restricted stock awards outstanding under the 2005 Plan as of September 30, 2011, and the activity during the nine months then ended, are as follows (in thousands):

Shares

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|                                            |       |
|--------------------------------------------|-------|
| Unvested at December 31, 2010              | 1,604 |
| Granted (unaudited)                        | 985   |
| Cancelled/forfeited (unaudited)            | (266) |
| Vested (unaudited)                         | (638) |
| Unvested at September 30, 2011 (unaudited) | 1,685 |

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### **5. Fair Value of Financial Instruments**

The Company measures and discloses fair value measurements as required by FASB ASC Topic No. 820, Fair Value Measurements and Disclosures.

The carrying value of accounts receivable, foreign cash accounts, prepaid expenses, other current assets, accounts payable, and accrued expenses are considered to be representative of their respective fair values because of the short-term nature of those instruments.

Fair value is an exit price, representing the amount that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants. As such, fair value is a market-based measurement that is determined based on assumptions that market participants would use in pricing an asset or a liability. As a basis for considering such assumptions, the FASB establishes a three-tier value hierarchy, which prioritizes the inputs used in the valuation methodologies in measuring fair value:

Level 1 - Observable inputs that reflect quoted prices (unadjusted) for identical assets or liabilities in active markets.

Level 2 - Include other inputs that are directly or indirectly observable in the marketplace.

Level 3 - Unobservable inputs which are supported by little or no market activity.

The fair value hierarchy also requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value.

As required by FASB ASC Topic No. 820, we measure our cash equivalents and short-term investments at fair value. Our cash equivalents and short-term investments are classified within Level 1 by using quoted market prices utilizing market observable inputs.

As required by FASB ASC Topic No. 825, Financial Instruments, an entity can 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 are required to be reported in earnings in the current period. This Topic also establishes presentation and disclosure requirements for similar types of assets and liabilities measured at fair value. As permitted, the Company has elected not to use the fair value option to measure our available-for-sale securities under this Topic and will continue to report as required by FASB ASC Topic No. 320, Investments-Debt and Equity Securities. We have made this election because the nature of our financial assets and liabilities are not of such complexity that they would benefit from a change in valuation to fair value.

### **6. Cash and Cash Equivalents**

Cash and cash equivalents generally consist of cash, government securities, mutual funds, and money market funds. These securities are primarily held in two financial institutions and are uninsured except for the minimum Federal Deposit Insurance Corporation ( FDIC ) coverage, and have original maturity dates of three months or less. As of September 30, 2011 and December 31, 2010, bank balances totaling approximately \$15.9 million and \$17.6 million, respectively, were uninsured.

### **7. Short-Term Investments**

Short-term investments consist of U.S. government agency and government sponsored enterprise obligations. The Company accounts for these short-term investments as required by FASB ASC Topic No. 320, Investments-Debt and Equity Securities. These debt and equity securities are not classified as either held-to-maturity securities or trading securities. As such, they are classified as available-for-sale securities.

Available-for-sale securities are recorded at fair value, with unrealized gains or losses recorded as a separate component of accumulated other comprehensive income in stockholders' equity until realized. Available-for-sale securities with contractual maturities of less than 12 months were as follows (in thousands):

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|                                  | September 30, 2011 |                         |                               | December 31, 2010 |                         |                               |
|----------------------------------|--------------------|-------------------------|-------------------------------|-------------------|-------------------------|-------------------------------|
|                                  | Fair value         | Amortized<br>cost basis | Net unrealized<br>gain (loss) | Fair value        | Amortized<br>cost basis | Net unrealized<br>gain (loss) |
| Corporate notes, bonds and paper | \$ 27,677          | \$ 27,737               | \$ (36)                       | \$ 39,691         | \$ 39,704               | \$ (8)                        |
| Government securities            | 6,314              | 6,320                   | (4)                           | 15,003            | 15,007                  | (2)                           |
| Total                            | \$ 33,991          | \$ 34,057               | \$ (40)                       | \$ 54,694         | \$ 54,711               | \$ (10)                       |

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### **8. 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.

### **9. Inventories**

Inventories consist primarily of compact disks (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 September 30, 2011, our net inventory balance consisted of approximately \$0.2 million of assembled products and \$0.1 million of components.

### **10. 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.

The Company recorded an impairment charge against certain improvements in the amount of \$5.3 million for the three month period ended September 30, 2011. Please see Note 11, Impairment of Long-Lived Assets, below.

### **11. Goodwill and Long-Lived Assets**

#### *Goodwill*

The Company accounts for goodwill and other intangible assets in accordance with FASB ASC Topic No. 350, Intangibles-Goodwill and Other, which requires that goodwill and other identifiable intangible assets with indefinite useful lives be tested for impairment at least annually. The Company tests goodwill and intangible assets for impairment in December of each year, or more frequently if events and circumstances warrant. These assets are impaired if the Company determines that their carrying values may not be recoverable based on an assessment of certain events or changes in circumstances:

a determination that the carrying value of such assets cannot be recovered through undiscounted cash flows;

loss of legal ownership or title to the assets;

significant changes in our strategic business objectives and utilization of the assets; or

the impact of significant negative industry or economic trends.

If the assets are considered to be impaired, the Company recognizes the amount by which the carrying value of the assets exceeds the fair value of the assets as an impairment loss.

The goodwill impairment test is a two-step process. The first step compares the Company's fair value to its net book value. If the fair value is less than the net book value, the second step of the test compares the implied fair value of the Company's goodwill to its carrying amount. If the carrying amount of goodwill exceeds its implied fair value, the Company would recognize an impairment loss equal to that excess amount.

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The fair value of a reporting unit refers to the price that would be received to sell the unit as a whole in an orderly transaction between market participants at the measurement date. Quoted market prices in active markets are the best evidence of fair value and shall be used as the basis for the measurement, if available. However, the market price of an individual equity security (and thus the market capitalization of a reporting unit with publicly traded equity securities) may not be representative of the fair value of the reporting unit as a whole. Substantial value may arise from the ability to take advantage of synergies and other benefits that flow from control over another entity. Consequently, measuring the fair value of a collection of assets and liabilities that operate together in a controlled entity is different from measuring the fair value of that entity's individual equity securities. An acquiring entity often is willing to pay more for equity securities that gives it a controlling interest than an investor would pay for a number of equity securities representing less than a controlling interest. That control premium may cause the fair value of a reporting unit to exceed its market capitalization. The quoted market price of an individual equity security, therefore, need not be the sole measurement basis of the fair value of a reporting unit.

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At December 31, 2010, the Company estimated the fair value in Step 1 based on the income approach which included discounted cash flows as well as a market approach that utilized the Company's earnings and revenue multiples. The Company's discounted cash flows required management judgment with respect to forecasted revenues, launch of new products, operating expenses, working capital and the selection and use of an appropriate discount rate. The Company's assessment resulted in a fair value that was marginally greater than the Company's carrying values for the Productivity & Graphics operating unit and was significantly greater than the Company's carrying values for the Wireless operating unit at December 31, 2010. In accordance with the authoritative literature, the second step of the impairment test was not required to be performed and no impairment of goodwill was recorded as of December 31, 2010.

At June 30, 2011, the Company concluded that a decline in its stock price and market capitalization was not representative of the fair value of the reporting unit as a whole. The goodwill impairment test should be based on an other-than-temporary decline. The Company believed that it was more likely than not that the fair value of the Company's two reporting units had not declined below the reporting unit's carrying amount because there had been temporary declines in (1) the stock price, (2) revenues due to a technology shift in our marketplace resulting in our core connection management products experiencing lower demand in certain markets and (3) earnings as we continued to invest heavily in R&D to bring new products to market. There are several new products that we expected to launch during the second half of 2011 that would address the technology shift in the marketplace. As such, the Company expected these new products, should they be successful, to result in improved revenues and profitability during the second half of 2011.

At June 30, 2011, the Company stated that if its revenues, profitability, and stock price did not improve in the third and/or fourth quarter of 2011, we would more likely than not have to perform Step 1 of the impairment test. The triggering events we monitored were revenues, new product launches, profitability, and stock price.

During the period ended September 30, 2011, the Company concluded that a decline in its stock price and market capitalization was representative of the fair value of the reporting unit as a whole. The triggering events that led us to this conclusion were:

Revenues - declined for the third consecutive quarter.

New product launches although we are in trials for several of our new products, as of September 30, 2011 we have not realized any revenues from these new products.

Profitability declined for the third consecutive quarter.

Stock price has remained at depressed prices.

As such, the Company performed Step 1 of the impairment test. For both reporting units, fair value was determined by an average of a market approach and a discounted cash flow method. For the Wireless unit, the concluded fair value as of September 30, 2011 was approximately \$78.7 million and the carrying value was \$172.6 million which failed Step 1 and triggered Step 2. For the Productivity & Graphics unit, the concluded fair value as of September 30, 2011 was approximately \$5.7 million and the carrying value was \$16.8 million which failed Step 1 and triggered Step 2. For Step 2, the implied fair value of goodwill was measured (as the excess of the fair value of a reporting unit over the amounts assigned to its assets and liabilities, including any unrecognized intangible assets), and compared to the carrying value of goodwill. The inputs measured at fair value used in this valuation methodology were considered Level 3 in the three-tier value hierarchy per FASB ASC Topic No. 820, Fair Value Measurements and Disclosures. The excess (if any) of the carrying value of goodwill was compared to the implied fair value of goodwill and resulted in an impairment loss of \$94.2 million in the fiscal quarter ended September 30, 2011.

The following table sets forth the change in the carrying amount of goodwill balances as of September 30, 2011 and December 31, 2010 (in thousands):

|                                 | Wireless  | Productivity &<br>Graphics | Total     |
|---------------------------------|-----------|----------------------------|-----------|
| Balance as of December 31, 2010 | \$ 84,616 | \$ 9,615                   | \$ 94,231 |

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### Accumulated impairment losses

|                                  |          |         |          |
|----------------------------------|----------|---------|----------|
| Balance as of June 30, 2011      | 84,616   | 9,615   | 94,231   |
| Impairment losses                | (84,616) | (9,615) | (94,231) |
| Balance as of September 30, 2011 | \$       | \$      | \$       |

### *Impairment of Long-Lived Assets*

The Company assesses potential impairment to its long-lived assets as required by FASB ASC Topic No. 360, Property, Plant, and Equipment, when there is evidence that events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. An impairment loss is recognized when the carrying amount of the long-lived assets is not recoverable if it

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exceeds the sum of the undiscounted cash flows expected to result from the use and eventual disposition of the asset. Any required impairment loss is measured as the amount by which the carrying amount of a long-lived asset exceeds its fair value and is recorded as a reduction in the carrying value of the related asset and a charge to operating results.

As a result of the triggering events described above in our goodwill impairment analysis, the Company reviewed its long-lived assets for recoverability. As a result of this analysis, the Company recognized a long-lived asset impairment charge of \$18.7 million in the fiscal quarter ended September 30, 2011 which was allocated pro-rata to the intangible assets of \$13.4 million and \$5.3 million to equipment and improvements, primarily related to our leasehold improvements. The inputs measured at fair value used in this valuation methodology were considered Level 3 in the three-tier value hierarchy per FASB ASC Topic No. 820, Fair Value Measurements and Disclosures.

The following table sets forth the change in the carrying amount of intangible asset balances as of September 30, 2011 and December 31, 2010 (in thousands):

|                                  | Wireless  | Productivity &<br>Graphics | Total     |
|----------------------------------|-----------|----------------------------|-----------|
| Balance as of December 31, 2010  | \$ 17,136 | \$ 2,323                   | \$ 19,459 |
| Accumulated amortization         | (3,539)   | (520)                      | (4,059)   |
| Accumulated impairment losses    |           |                            |           |
| Balance as of June 30, 2011      | 13,597    | 1,803                      | 15,400    |
| Amortization                     | (1,767)   | (258)                      | (2,025)   |
| Impairment losses                | (11,830)  | (1,545)                    | (13,375)  |
| Balance as of September 30, 2011 | \$        | \$                         | \$        |

**12. Intangible Assets**

The following table sets forth our acquired intangible assets by major asset class as of September 30, 2011 and December 31, 2010 (in thousands except useful life data):

|                        | Useful<br>life<br>(years) | September 30, 2011 |                             |                          |                      | December 31, 2010 |             |                             |                   |
|------------------------|---------------------------|--------------------|-----------------------------|--------------------------|----------------------|-------------------|-------------|-----------------------------|-------------------|
|                        |                           | Gross              | Accumulated<br>amortization | Net book<br>value before | Impairment<br>Charge | Net book<br>value | Gross       | Accumulated<br>amortization | Net book<br>value |
| <i>Amortizing:</i>     |                           |                    |                             |                          |                      |                   |             |                             |                   |
| Purchased technology   | 1-3                       | \$ 7,347           | \$ (6,783)                  | \$ 564                   | \$ (564)             | \$ 7,347          | \$ (5,344)  | \$ 2,003                    |                   |
| In process R&D         | 2                         | 990                | (248)                       | 742                      | (742)                | 990               | (62)        | 928                         |                   |
| Capitalized software   | 1-7                       | 23,846             | (17,673)                    | 6,173                    | (6,173)              | 23,846            | (15,336)    | 8,510                       |                   |
| Customer lists         | 3-5                       | 1,484              | (1,461)                     | 23                       | (23)                 | 1,484             | (1,328)     | 156                         |                   |
| Database               | 10                        | 182                | (70)                        | 112                      | (112)                | 182               | (56)        | 126                         |                   |
| Trademarks             | 5-10                      | 926                | (605)                       | 321                      | (321)                | 926               | (537)       | 389                         |                   |
| Trade names            | 1-7                       | 2,121              | (1,506)                     | 615                      | (615)                | 2,121             | (1,208)     | 913                         |                   |
| Non-compete            | 2                         | 21                 | (18)                        | 3                        | (3)                  | 21                | (13)        | 8                           |                   |
| Customer relationships | 4-7                       | 11,130             | (6,308)                     | 4,822                    | (4,822)              | 11,130            | (4,704)     | 6,426                       |                   |
| Totals                 |                           | \$ 48,047          | \$ (34,672)                 | \$ 13,375                | \$ (13,375)          | \$ 48,047         | \$ (28,588) | \$ 19,459                   |                   |

Aggregate amortization expense on intangible assets prior to the impairment charge was \$2.1 million and \$6.1 million for the three and nine months ended September 30, 2011. There is no future amortization expense on these intangible assets due to the recorded impairment.



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### 13. Comprehensive Income

Comprehensive income includes unrealized gains and losses on short-term investments of U.S. government agency and government sponsored enterprise debt and equity securities. The following table sets forth the calculation of comprehensive income (in thousands):

|                                                      | Three Months Ended September 30, |          | Nine Months Ended September 30, |          |
|------------------------------------------------------|----------------------------------|----------|---------------------------------|----------|
|                                                      | 2011                             | 2010     | 2011                            | 2010     |
|                                                      | (unaudited)                      |          | (unaudited)                     |          |
| Net income (loss)                                    | \$ (134,481)                     | \$ 3,094 | \$ (150,081)                    | \$ 6,571 |
| Change in unrealized gain (loss) on investments, net | (29)                             | 2        | (30)                            | (10)     |
| Total comprehensive income (loss)                    | \$ (134,510)                     | \$ 3,096 | \$ (150,111)                    | \$ 6,561 |

### 14. Segment and Geographical Information

#### Segment Information

Public companies are required to report financial and descriptive information about their reportable operating segments as required by FASB ASC Topic No. 280, Segment Reporting. The Company has two primary business units based on how management internally evaluates separate financial information, business activities and management responsibility. Wireless includes our connectivity and security management, mobile VPN, media and content management, device management, Push-To-Talk, Visual Voicemail, Visual Voicemail to Text, contact and calendar syncing and video content delivery and optimization solutions. Productivity & Graphics includes retail and direct sales of our compression and broad consumer-based software. Corporate/Other revenue includes the consulting portion of our services sector which has been de-emphasized and is no longer considered a strategic element of our future plans.

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

The following table shows the revenues generated by each business unit (in thousands):

|                         | Three Months Ended September 30, |           | Nine Months Ended September 30, |           |
|-------------------------|----------------------------------|-----------|---------------------------------|-----------|
|                         | 2011                             | 2010      | 2011                            | 2010      |
|                         | (unaudited)                      |           | (unaudited)                     |           |
| Wireless                | \$ 10,211                        | \$ 31,340 | \$ 40,000                       | \$ 86,631 |
| Productivity & Graphics | 2,365                            | 2,615     | 6,339                           | 8,296     |
| Corporate/Other         | 56                               | 53        | 189                             | 300       |
| Total Revenues          | \$ 12,632                        | \$ 34,008 | \$ 46,528                       | \$ 95,227 |

Revenues to three customers and their respective affiliates in the Wireless business segment accounted for 24.8%, 20.6% and 11.6% of the Company's total revenues for the three months ended September 30, 2011. Revenues to three customers and their respective affiliates in the Wireless business segment accounted for 41.7%, 15.0% and 11.9% of the Company's total revenues for the three months ended September 30, 2010. Revenues to three customers and their respective affiliates in the Wireless business segment accounted for 23.5%, 19.6% and 11.9% of the Company's total revenues for the nine months ended September 30, 2011. Revenues to three customers and their respective affiliates in the Wireless business segment accounted for 36.5%, 14.7% and 14.6% of the Company's total revenues for the nine months ended September 30, 2010.

The following table shows the goodwill and intangible assets by each business unit (in thousands):

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|                               | September 30, 2011<br>(unaudited) | December 31, 2010<br>(audited) |
|-------------------------------|-----------------------------------|--------------------------------|
| Goodwill                      | \$                                | \$ 84,616                      |
| Intangibles-net               |                                   | 17,136                         |
| Total Wireless                |                                   | 101,752                        |
| Goodwill                      |                                   | 9,615                          |
| Intangibles-net               |                                   | 2,323                          |
| Total Productivity & Graphics |                                   | 11,938                         |
| Total                         | \$                                | \$ 113,690                     |

**Table of Contents***Geographical Information*

During the three and nine months ended September 30, 2011 and 2010, the Company operated in three geographic locations; the Americas, Asia Pacific, and EMEA (Europe, the Middle East, and Africa). Revenues, attributed to the geographic location of the customer's bill-to address, were as follows (in thousands):

|                | Three Months Ended September 30, |           | Nine Months Ended September 30, |           |
|----------------|----------------------------------|-----------|---------------------------------|-----------|
|                | 2011                             | 2010      | 2011                            | 2010      |
|                | (unaudited)                      |           | (unaudited)                     |           |
| Americas       | \$ 11,153                        | \$ 32,384 | \$ 42,085                       | \$ 88,169 |
| EMEA           | 663                              | 1,226     | 2,490                           | 5,827     |
| Asia Pacific   | 816                              | 398       | 1,953                           | 1,231     |
| Total Revenues | \$ 12,632                        | \$ 34,008 | \$ 46,528                       | \$ 95,227 |

The Company does not separately allocate specific assets to these geographic locations.

**15. Recent Accounting Pronouncements**

In September 2011, the FASB issued Accounting Standards Update (ASU) No. 2011-08, *Intangibles-Goodwill and Other (Topic 350): Testing Goodwill for Impairment*. Under the amendments in this Update, an entity has the option to first assess qualitative factors to determine whether the existence of events or circumstances leads to a determination that it is more likely than not that the fair value of a reporting unit is less than its carrying amount. If, after assessing the totality of events or circumstances, an entity determines it is not more likely than not that the fair value of a reporting unit is less than its carrying amount, then performing the two-step impairment test is unnecessary. However, if an entity concludes otherwise, then it is required to perform the first step of the two-step impairment test by calculating the fair value of the reporting unit and comparing the fair value with the carrying amount of the reporting unit. If the carrying amount of a reporting unit exceeds its fair value, then the entity is required to perform the second step of the goodwill impairment test to measure the amount of the impairment loss, if any. Under the amendments in this Update, an entity has the option to bypass the qualitative assessment for any reporting unit in any period and proceed directly to performing the first step of the two-step goodwill impairment test. An entity may resume performing the qualitative assessment in any subsequent period. The Company has adopted ASU No. 2011-8 and its adoption did not have an impact on its consolidated results of operations and financial condition as the Company elected the option to bypass the qualitative assessment and proceed directly to performing step one of the goodwill impairment test for the period ended September 30, 2011. The Company recorded a goodwill impairment charge of \$94.2 million for the period ending September 30, 2011.

In June 2011, the FASB issued ASU No. 2011-05, *Comprehensive Income (Topic 220): Presentation of Comprehensive Income*. Under the amendments to this Update, an entity has the option to present the total of comprehensive income, the components of net income, and the components of other comprehensive income either in a single continuous statement of comprehensive income or in two separate but consecutive statements. In both choices, an entity is required to present each component of net income along with total net income, each component of other comprehensive income along with a total for other comprehensive income, and a total amount for comprehensive income. This Update eliminates the option to present the components of other comprehensive income as part of the statement of changes in stockholders' equity. The amendments in this Update do not change the items that must be reported in other comprehensive income or when an item of other comprehensive income must be reclassified to net income. For the Company, this guidance is effective for fiscal years, and interim periods within those years, beginning after December 15, 2011. Early adoption is permitted. The Company is currently assessing its implementation of this new guidance.

In May 2011, the FASB issued ASU No. 2011-04, *Fair Value Measurements and Disclosures (Topic 820): Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs*. The amendments in this Update result in common fair value measurement and disclosure requirements in U.S. GAAP and IFRSs. Consequently, the amendments change the wording used to describe many of the requirements in U.S. GAAP for measuring fair value and for disclosing information about fair value measurements. For many of the requirements, the Board does not intend for the amendments in this Update to result in a change in the application of the requirements in Topic 820. Some of the amendments clarify the Board's intent about the application of existing fair value measurement requirements. Other amendments change a particular principle or requirement for measuring fair value or for disclosing information about fair value measurements. For the Company, this guidance is effective for fiscal years, and interim periods within those years, beginning after December 15, 2011. Early

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adoption is not permitted. The Company is currently assessing its implementation of this new guidance, but does not expect a material impact on the consolidated financial statements.

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In December 2010, the FASB issued ASU No. 2010-28, *Intangibles-Goodwill and Other (Topic 350): When to Perform Step 2 of the Goodwill Impairment Test for Reporting Units with Zero or Negative Carrying Amounts (a consensus of the FASB Emerging Issues Task Force)*. The amendments in this ASU modify Step 1 of the goodwill impairment test for reporting units with zero or negative carrying amounts. For those reporting units, an entity is required to perform Step 2 of the goodwill impairment test if it is more likely than not that a goodwill impairment exists. In determining whether it is more likely than not that a goodwill impairment exists, an entity should consider whether there are any adverse qualitative factors indicating that an impairment may exist. The qualitative factors are consistent with the existing guidance which requires that goodwill of a reporting unit be tested for impairment between annual tests if an event occurs or circumstances change that would more likely than not reduce the fair value of a reporting unit below its carrying amount. For the Company, this guidance is effective for fiscal years, and interim periods within those years, beginning after December 15, 2010. Early adoption is not permitted. The Company has adopted ASU No. 2010-28 and its adoption has not had an impact on its consolidated results of operations and financial condition.

In October 2009, the FASB issued ASU No. 2009-14, *Software (Topic 985): Certain Revenue Arrangements That Include Software Elements (a consensus of the FASB Emerging Issues Task Force)*. This new guidance amends the scope of existing software revenue recognition accounting. Tangible products containing software components and non-software components that function together to deliver the product's essential functionality would be scoped out of the accounting guidance on software and accounted for based on other appropriate revenue recognition guidance. For the Company, this guidance is effective for all new or materially modified arrangements entered into on or after January 1, 2011 with earlier application permitted as of the beginning of a fiscal year. Full retrospective application of the new guidance is optional. This guidance must be adopted in the same period that the company adopts the amended accounting for arrangements with multiple deliverables described in the next paragraph. The Company has adopted ASU No. 2009-14 and its adoption has not had an impact on its consolidated results of operations and financial condition.

In October 2009, the FASB issued ASU No. 2009-13, *Revenue Recognition (Topic 605): Multiple-Deliverable Revenue Arrangements*. ASU No. 2009-13 amends revenue recognition guidance for arrangements with multiple deliverables. The new guidance eliminates the residual method of revenue recognition and allows the use of management's best estimate of selling price for individual elements of an arrangement when vendor specific objective evidence (VSOE), vendor objective evidence (VOE) or third-party evidence (TPE) is unavailable. For the Company, this guidance is effective for all new or materially modified arrangements entered into on or after January 1, 2011 with earlier application permitted as of the beginning of a fiscal year. Full retrospective application of the new guidance is optional. The Company has adopted ASU No. 2009-13 and its adoption has not had an impact on its consolidated results of operations and financial condition.

**16. Commitments and Contingencies***Leases*

The Company leases its buildings under operating leases that expire on various dates through 2022. Future minimum annual lease payments under such leases as of September 30, 2011 are as follows (in thousands):

| <b>Year Ending December 31,</b> | <b>Operating</b> |
|---------------------------------|------------------|
| 2011-3 months                   | \$ 619           |
| 2012                            | 2,830            |
| 2013                            | 2,860            |
| 2014                            | 2,479            |
| 2015                            | 2,383            |
| 2016                            | 2,127            |
| Beyond                          | 7,240            |
| <b>Total</b>                    | <b>\$ 20,538</b> |

Rent expense under operating leases for the three months ended September 30, 2011 and 2010 was \$0.7 million and \$0.6 million, respectively. Rent expense under operating leases for the nine months ended September 30, 2011 and 2010 was \$2.2 million and \$1.8 million, respectively.

As a condition of our new lease in Pittsburgh, the landlord agreed to incentives of \$40.00 per square foot, or a total of \$2.2 million, for improvements to the space. These costs have been included in deferred rent in our long-term liabilities and are being amortized over the remaining lease term.



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### *Pennsylvania Opportunity Grant Program*

On September 26, 2011, we received \$1.0 million from the State of Pennsylvania to help fund our agreement to start-up a new facility. The grant carries with it an obligation, or commitment, to employ at least 232 people within a three-year time period. This grant contains conditions that would require us to return a pro-rata amount of the monies received if we fail to meet these conditions. As such, the monies have been recorded as a liability until we are irrevocably entitled to retain the monies.

### *Litigation*

On June 29, 2011, a complaint was filed in the U.S. District Court for the Central District of California against us and certain of our current and past officers and directors on behalf of certain purchasers of our common stock. The complaint has been brought as a purported stockholder class action, and, in general, includes allegations that we and certain of our officers and directors violated federal securities laws by making materially false and misleading statements regarding our business prospects and financial results, thereby artificially inflating the price of our common stock. The plaintiff is seeking unspecified monetary damages and other relief. On August 29, 2011, two prospective lead plaintiffs filed motions for appointment of lead plaintiff and for appointment of lead counsel. On October 17, 2011, the court appointed the two prospective lead plaintiffs as co-lead plaintiffs and their respective counsel as co-lead counsel. We expect the co-lead plaintiffs to file an amended complaint. We intend to vigorously defend against the claims advanced, and intend to file a motion to dismiss the amended complaint.

On August 11, 2011, a shareholder derivative complaint was filed in the Superior Court of California for the County of Orange against the Company's directors and certain of its executive officers. Thereafter, two additional similar complaints, also styled as shareholder derivative actions, were filed in state court (collectively, the "State Derivative Actions"). On September 12, 2011, a shareholder derivative complaint was filed in the U.S. District Court for the Central District of California against certain of the officers and directors named in the State Derivative Actions but also against additional officers of the company (the "Federal Derivative Action"). Collectively, the State Derivative Actions and the Federal Derivative Action are referred to as the "Derivative Actions." The complaints in the Derivative Actions allege breaches of fiduciary duties by the defendants and other violations of state law. In general, the complaints in the Derivative Actions allege that the Company's directors and certain of its officers caused or allowed for the dissemination of materially false and misleading statements regarding our business prospects and financial results, thereby artificially inflating the price of our common stock. Plaintiffs in the Derivative Actions seek unspecified monetary damages and other relief, including reforms and improvements to the Company's corporate governance and internal procedures. We intend to vigorously defend against the claims advanced in the Derivative Actions, and intend to file demurrers and/or motion(s) to dismiss the complaints in the Derivative Actions.

The Company is and may become involved in various other legal proceedings arising from its business activities. While management does not believe the ultimate disposition of these matters will have a material adverse impact on the Company's consolidated results of operations, cash flows or financial position, litigation is inherently unpredictable, and depending on the nature and timing of these proceedings, an unfavorable resolution could materially affect the Company's future consolidated results of operations, cash flows or financial position in a particular period.

## **17. Income Taxes**

We account for income taxes as required by FASB ASC Topic No. 740, Income Taxes. This Topic clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements and prescribes a recognition threshold and measurement process for financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. The Topic also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. 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, we are required to evaluate the probability of being able to realize the future benefits indicated by such asset. The Company records a valuation allowance to reduce any deferred tax assets by the amount of any tax benefits that, based on available evidence and judgment, are not expected to be realized.

The Company assesses whether a valuation allowance should be recorded against its deferred tax assets based on the consideration of all available evidence, using a "more likely than not" realization standard. The four sources of taxable income that must be considered in determining whether deferred tax assets will be realized are: (1) future reversals of existing taxable temporary differences (i.e., offset of gross deferred tax assets against gross deferred tax liabilities); (2) taxable income in prior carryback years, if carryback is permitted under the applicable tax law; (3) tax planning strategies and (4) future taxable income exclusive of reversing temporary differences and carryforwards.



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In assessing whether a valuation allowance is required, significant weight is to be given to evidence that can be objectively verified. A significant factor in the Company's assessment is that the Company is in a three-year historical cumulative loss as of the end of the third quarter of 2011. This fact, combined with uncertain near-term market and economic conditions, reduced the Company's ability to rely on projections of future taxable income in assessing the realizability of its deferred tax assets.

After a review of the four sources of taxable income as of September 30, 2011 (as described above), and after consideration of the Company's three year cumulative loss position as of September 30, 2011, the Company recorded a valuation allowance related to its U.S.-based deferred tax amounts, with a corresponding charge to income tax expense, of \$48.1 million during the quarter ended September 30, 2011.

We recorded an income tax provision of \$6.5 million and income tax benefit \$3.9 million for the three and nine months ended September 30, 2011, respectively. We recorded income tax expenses of \$2.9 million and \$6.0 million for the three and nine months ended September 30, 2010, respectively. The effective tax rate for the nine months ended September 30, 2011 was 2.5%, which was lower than the 47.7% for the nine months ended September 30, 2010, primarily due to the valuation allowance and carryback of losses to offset taxable income in prior years.

In July 2006, the FASB clarified the accounting for uncertainty in income taxes recognized in the financial statements. A tax benefit from an uncertain tax position may be recognized when it is more likely than not that the position will be sustained upon examination, including resolutions of any related appeals or litigation process, based on the technical merits. The Company adopted this FASB guidance effective January 1, 2007 and did not record any unrecognized tax benefits from uncertain tax positions at adoption. Based on our evaluation for the nine months ended September 30, 2011, we have concluded that there are no significant uncertain tax positions requiring recognition on our financial statements. Our evaluation was performed for the tax years ended December 31, 2007, 2008, 2009 and 2010, the tax years which remain subject to examination by major tax jurisdictions as of September 30, 2011.

We may from time to time be assessed interest or penalties by major tax jurisdictions, although any such assessments historically have been minimal and immaterial to our financial results. It is the Company's policy to classify any interest and/or penalties in the financial statements as a component of general and administrative expense.

In March 2011, the Internal Revenue Service began its examination of the Company's U.S. federal tax return for the year ended December 31, 2008. The exam is expected to be completed by the first fiscal quarter of 2012.

**18. Restructuring Expenses**

On July 19, 2011, we announced that our Chicago facility would be permanently closed as of September 30, 2011. In addition, we had a small reduction of headcount in other areas of the Company. Subsequent to September 30, 2011, but before the filing of this Form 10-Q, we announced a material Restructuring Plan that was approved by our Board of Directors on October 18, 2011. Since the charges for the Restructuring Plan approved on October 18, 2011 are material, we chose to start reporting these types of expenses for the period ended September 30, 2011, although the actual expenses incurred prior to September 30, 2011 were immaterial.

The following is the activity in our restructuring liability account for the period ended September 30, 2011 (in thousands):

|                                        | June 30, 2011<br>Balance | Provision | Usage    | Reclass | September 30, 2011<br>Balance |
|----------------------------------------|--------------------------|-----------|----------|---------|-------------------------------|
| One-time employee termination benefits | \$                       | \$ 410    | \$ (68)  | \$      | \$ 342                        |
| Lease/rental terminations              |                          | 383       |          |         | 383                           |
| Relocation, move, other expenses       |                          | 191       | (191)    | 9       | 9                             |
| Total                                  | \$                       | \$ 984    | \$ (259) | \$ 9    | \$ 734                        |

The Restructuring Plan approved on October 18, 2011 involves a realignment of organizational structures, facility consolidations/closures and headcount reductions that will amount to approximately 20% of the Company's worldwide workforce. The Restructuring Plan is expected to be implemented primarily during the fourth quarter of the Company's 2011 fiscal year. Although estimates are subject to change as additional information becomes available, the Company currently expects that implementation of the Restructuring Plan will result in special charges totaling approximately \$2.0-2.5 million which will be recorded during the fourth quarter of 2011. These charges will be primarily for severance costs for affected employees, which are estimated at approximately \$1.5-2.0 million. Of the total charges, all but approximately \$0.4 million will

be cash expenditures. Of the cash expenditures, all but approximately \$0.4 million are expected to be paid out in the fourth quarter.

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**19. Subsequent Events**

The Company evaluates and discloses subsequent events as required by ASC Topic No. 855, Subsequent Events. The Topic establishes general standards of accounting for and disclosure of events that occur after the balance sheet date but before the financial statements are issued or are available to be issued.

On November 2, 2011, the Company announced that its Board of Directors had approved a program authorizing the repurchase of up to five million shares of the company's common stock over a period of up to two years. Under this program, stock repurchases may be made from time to time and the actual amount expended will depend on a variety of factors including market conditions, regulatory and legal requirements, corporate cash generation and other factors. The stock repurchases may be made in both open market and privately negotiated transactions, and may include the use of Rule 10b5-1 trading plans. The program does not obligate Smith Micro to repurchase any particular amount of common stock during any period and the program may be modified or suspended at any time at the company's discretion.

Subsequent events have been evaluated as of the date of this filing and no further disclosures were required.

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

*In this document, the terms Smith Micro, Company, we, us, and our refer to Smith Micro Software, Inc. and, where appropriate, its subsidiaries.*

*This report contains forward-looking statements regarding Smith Micro which include, but are not limited to, statements concerning projected revenues, expenses, gross profit and income, the competitive factors affecting our business, market acceptance of products, customer concentration, the success and timing of new product introductions and the protection of our intellectual property. These forward-looking statements are based on our current expectations, estimates and projections about our industry, management's beliefs, and certain assumptions made by us. Words such as anticipates, expects, intends, plans, predicts, potential, believes, seeks, estimates, should, may, will and variations of these words or similar expressions are intended to identify forward-looking statements. Forward-looking statements also include the assumptions underlying or relating to any of the foregoing statements. These statements are not guarantees of future performance and are subject to risks, uncertainties and assumptions that are difficult to predict. Therefore, our actual results could differ materially and adversely from those expressed or implied in any forward-looking statements as a result of various factors. Such factors include, but are not limited to, the following:*

*changes in demand for our products from our customers and their end-users;*

*our ability to predict consumer needs, introduce new products, gain broad market acceptance for such products and ramp up manufacturing in a timely manner;*

*our business and stock price may decline further which could cause an additional impairment of long-lived assets or restructuring charge resulting in a material adverse effect on our financial condition and results of operations;*

*the intensity of the competition and our ability to successfully compete;*

*the pace at which the market for new products develop;*

*the response of competitors, many of whom are bigger and better financed than us;*

*our ability to protect our intellectual property and our ability to not infringe on the rights of others;*

*our ability to successfully execute our business plan and control costs and expenses;*

*the continued economic slowdown and uncertainty and its effects on capital expenditures by our customers and their end users;*

*the amount of our legal expenses and our financial exposure to any adverse judgments or settlements associated with the outstanding securities litigation, and any future litigation that may arise, and the adequacy of our insurance policy coverage regarding those expenses and any damages or settlement payments related to such litigation; and*

*those additional factors which are listed under the section Risk Factors in this Report on Form 10-Q for the quarter ended September 30, 2011 and in our Annual Report on Form 10-K for the year ended December 31, 2010.*

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*The forward-looking statements contained in this report are made on the basis of the views and assumptions of management regarding future events and business performance as of the date this report is filed with the Securities and Exchange Commission (the "SEC"). We do not undertake any obligation to update these statements to reflect events or circumstances occurring after the date this report is filed.*

### Overview

Smith Micro Software, Inc. ( "we," "us," "our," "Smith Micro," or the "Company" ) designs, develops and markets software solutions primarily for the wireless industry. Our portfolio of products and services spans connectivity management and communications solutions that simplify, secure and enhance the mobile experience. The Company's connectivity clients are installed on millions of devices across 3G, 4G and Wi-Fi networks. Our QuickLink® product family has been expanded to include the Experience Manager and Mobile Network Director solutions for optimizing network resources and increasing average-revenue-per-user ( "ARPU" ) for wireless operators. Our mobile communications solutions, which include Push-To-Talk, Visual Voicemail, Voice-

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to-Text, and Vidio , are used by leading wireless operators around the world. Our device management products are sold to original equipment manufacturers ( OEM ), device manufacturers and enterprise businesses to reduce the cost of ownership and enable secure connectivity for mobile devices.

Our innovative line of productivity and graphics products are distributed through a variety of consumer channels worldwide, our online stores, and third-party wholesalers, retailers and value-added resellers. We offer products that operate on Windows, Mac, UNIX, Linux, Apple iPhone/iPad, Android, Windows Mobile, Symbian and Java platforms.

Revenues to three customers and their respective affiliates in the Wireless business segment accounted for 24.8%, 20.6% and 11.6% of the Company's total revenues for the three months ended September 30, 2011. Revenues to three customers and their respective affiliates in the Wireless business segment accounted for 41.7%, 15.0% and 11.9% of the Company's total revenues for the three months ended September 30, 2010. Revenues to three customers and their respective affiliates in the Wireless business segment accounted for 23.5%, 19.6% and 11.9% of the Company's total revenues for the nine months ended September 30, 2011. Revenues to three customers and their respective affiliates in the Wireless business segment accounted for 36.5%, 14.7% and 14.6% of the Company's total revenues for the nine months ended September 30, 2010.

**Results of Operations**

The table below sets forth certain statements of operations data expressed as a percentage of revenues for the three and nine months ended September 30, 2011 and 2010. Our historical results are not necessarily indicative of the operating results that may be expected in the future.

|                                          | Three Months Ended<br>September 30, |        | Nine Months Ended<br>September 30, |        |
|------------------------------------------|-------------------------------------|--------|------------------------------------|--------|
|                                          | 2011                                | 2010   | 2011                               | 2010   |
| Revenues                                 | 100.0%                              | 100.0% | 100.0%                             | 100.0% |
| Cost of revenues                         | 29.3                                | 11.1   | 23.7                               | 12.0   |
| Gross profit                             | 70.7                                | 88.9   | 76.3                               | 88.0   |
| Operating expenses:                      |                                     |        |                                    |        |
| Selling and marketing                    | 51.1                                | 21.6   | 47.1                               | 23.1   |
| Research and development                 | 84.7                                | 32.3   | 72.4                               | 32.8   |
| General and administrative               | 46.5                                | 17.8   | 43.1                               | 19.0   |
| Restructuring expenses                   | 7.8                                 |        | 2.1                                |        |
| Goodwill and long-lived asset impairment | 893.8                               |        | 242.7                              |        |
| Total operating expenses                 | 1083.9                              | 71.7   | 407.4                              | 74.9   |
| Operating income (loss)                  | (1013.2)                            | 17.2   | (331.1)                            | 13.1   |
| Interest and other income                | 0.1                                 | 0.3    | 0.2                                | 0.1    |
| Income (loss) before taxes               | (1013.1)                            | 17.5   | (330.9)                            | 13.2   |
| Income tax expense (benefit)             | 51.5                                | 8.4    | (8.3)                              | 6.3    |
| Net income (loss)                        | (1064.6)%                           | 9.1%   | (322.6)%                           | 6.9%   |

**Revenues and Expense Components**

The following is a description of the primary components of our revenues and expenses:

*Revenues.* Revenues are net of sales returns and allowances. Our operations are organized into two business segments:

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Wireless, which includes our connectivity and security management, mobile VPN, media and content management, device management, Push-To-Talk, Visual Voicemail, Visual Voicemail to Text, contact and calendar syncing, video content delivery and optimization solutions and managed file transfers; and

Productivity & Graphics, which includes retail and direct sales of our compression and broad consumer-based software.

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The following table shows the revenues generated by each business segment (in thousands):

|                         | Three Months Ended September 30, |           | Nine Months Ended September 30, |           |
|-------------------------|----------------------------------|-----------|---------------------------------|-----------|
|                         | 2011                             | 2010      | 2011                            | 2010      |
| Wireless                | \$ 10,211                        | \$ 31,340 | \$ 40,000                       | \$ 86,631 |
| Productivity & Graphics | 2,365                            | 2,615     | 6,339                           | 8,296     |
| Corporate/Other         | 56                               | 53        | 189                             | 300       |
| Total revenues          | 12,632                           | 34,008    | 46,528                          | 95,227    |
| Cost of revenues        | 3,699                            | 3,771     | 11,035                          | 11,468    |
| Gross profit            | \$ 8,933                         | \$ 30,237 | \$ 35,493                       | \$ 83,759 |

Corporate/Other refers to the consulting portion of our services sector which has been de-emphasized and is no longer considered a strategic element of our future plans.

*Cost of revenues.* Cost of revenues consists of direct product costs, royalties, and the amortization of purchased intangibles and capitalized software.

*Selling and marketing.* Selling and marketing expenses consist primarily of personnel costs, advertising costs, sales commissions, trade show expenses, and the amortization of certain purchased intangibles. These expenses vary significantly from quarter to quarter based on the timing of trade shows and product introductions.

*Research and development.* Research and development expenses consist primarily of personnel and equipment costs required to conduct our software development efforts and the amortization of certain acquired intangibles.

*General and administrative.* General and administrative expenses consist primarily of personnel costs, professional services and fees paid for external service providers, space and occupancy costs, and legal and other public company costs.

*Restructuring expenses.* Restructuring expenses consist primarily of one-time employee termination benefits, lease and other contract terminations and costs to consolidate facilities and relocate employees.

*Goodwill and long-lived asset impairment.* Goodwill and long-lived asset impairment charges are a result of determining that the recoverability of the carrying value of goodwill, intangible assets, and fixed assets will not be realized.

*Interest and other income.* Interest and other income are directly related to our average cash and short term investment balances during the period and vary among periods. Our other excess cash is invested in short term marketable equity and debt securities classified as cash equivalents.

*Income tax expense.* The Company accounts for income taxes as required by FASB ASC Topic No. 740, 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. Measurement of the deferred items is based on enacted tax laws. In the event the future consequences of differences between financial reporting bases and tax bases of the Company's assets and liabilities result in a deferred tax asset, we are required to evaluate the probability of being able to realize the future benefits indicated by such asset. The deferred tax assets are reduced by a valuation allowance if, based upon all available evidence, it is more likely than not that some or all of the deferred tax assets will not be realized. Establishing, reducing or increasing a valuation allowance in an accounting period generally results in an increase or decrease in tax expense in the statement of operations. We must make significant judgments to determine the provision for income taxes, deferred tax assets and liabilities, unrecognized tax benefits and any valuation allowance to be recorded against deferred tax assets. After consideration of the Company's three year cumulative loss position as of September 30, 2011 and sources of taxable income, the Company recorded a valuation allowance related to its U.S.-based deferred tax amounts, with a corresponding charge to income tax expense, of \$48.1 million during the quarter ended September 30, 2011.

**Three Months Ended September 30, 2011 Compared to the Three Months Ended September 30, 2010**

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*Revenues.* Revenues were \$12.6 million and \$34.0 million for the three months ended September 30, 2011 and 2010, respectively, representing a decrease of \$21.4 million, or 62.9%. Wireless revenues of \$10.2 million decreased \$21.1 million, or 67.4%, primarily due to continued lower sales of our base business connection manager products. Productivity & Graphics revenues of \$2.4 million decreased \$0.3 million, or 9.6% due to low consumer spending and moving toward a more internal distribution model.

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Due to the introduction and market acceptance of mobile hotspot devices, tablets and smartphones capable of functioning as a WWAN hotspot, our core connection management products are experiencing lower demand in our North American marketplace. While we have launched new wireless products that address this technology shift, they are new to the market and have not yet been adopted and thus there is a material uncertainty regarding our future wireless revenues.

*Cost of revenues.* Cost of revenues was \$3.7 million and \$3.8 million for the three months ended September 30, 2011 and 2010, representing a decrease of \$0.1 million, or 1.9%. Direct product costs increased \$0.1 million primarily due to new third party royalties. Amortization of intangibles decreased from \$1.5 million to \$1.3 million, or \$0.2 million. No future amortization of intangibles is anticipated as these assets have been fully impaired.

*Gross profit.* Gross profit was \$8.9 million, or 70.7% of revenues for the three months ended September 30, 2011, a decrease of \$21.3 million, or 70.5%, from \$30.2 million, or 88.9% of revenues for the three months ended September 30, 2010. The 18.2 percentage point decrease was primarily due to lower product margins of 12.8 points as a result of the lower revenues not absorbing our datacenter-related fixed costs associated with our backup and messaging products and higher third party royalties. Amortization of intangibles as a percentage of revenues increased 5.4 points primarily due to the lower revenues.

*Selling and marketing.* Selling and marketing expenses were \$6.4 million and \$7.3 million for the three months ended September 30, 2011 and 2010, respectively, representing a decrease of \$0.9 million, or 12.1%. This decrease was primarily due to lower headcount and people related costs of \$0.3 million and lower advertising spending of \$0.2 million. Stock-based compensation expense decreased from \$0.8 million to \$0.4 million, or \$0.4 million. Amortization of intangibles remained flat at \$0.7 million for the two fiscal quarters. No future amortization of intangibles is anticipated as these assets have been fully impaired.

*Research and development.* Research and development expenses were \$10.7 million and \$11.0 million for the three months ended September 30, 2011 and 2010, respectively, representing a decrease of \$0.3 million, or 2.5%. Headcount and people related costs increased \$0.2 million partially offset by lower travel and other expenses of \$0.1 million. This increase was offset by lower stock-based compensation expense which decreased from \$0.7 million to \$0.2 million, or \$0.5 million. Amortization of intangibles increased from zero to \$0.1 million. No future amortization of intangibles is anticipated as these assets have been fully impaired.

*General and administrative.* General and administrative expenses were \$5.9 million and \$6.1 million for the three months ended September 30, 2011 and 2010, respectively, representing a decrease of \$0.2 million, or 3.0%. Space and occupancy costs associated with facility expansions increased by \$0.7 million and legal expenses increased by \$0.2 million. These increases were offset by stock-based compensation expense which decreased from \$1.3 million to \$0.7 million, or \$0.6 million. Other expenses decreased by \$0.5 million due lower people-related and other expenses.

*Restructuring expenses.* Restructuring expenses of \$1.0 million for the three months ended September 30, 2011 were related to the Chicago facility shutdown of \$0.8 million and other one-time employee termination benefits of \$0.2 million. There were no restructuring expenses in 2010. As a result of a Restructuring Plan approved on October 18, 2011, we anticipate additional restructuring expenses in the range of \$2.0-2.5 million to be recorded during the fourth quarter of 2011.

*Goodwill and long-lived asset impairment.* Goodwill and long-lived asset impairment charges of \$112.9 million for the three months ended September 30, 2011 were related to goodwill of \$94.2 million, intangible assets of \$13.4 million, and fixed assets of \$5.3 million. There were no impairment charges in 2010.

*Income tax provision.* We recorded an income tax provision of \$6.5 million and \$2.9 million for the three months ended September 30, 2011 and 2010, respectively. The effective tax rate for the three months ended September 30, 2011 was impacted by the valuation allowance and carryback of losses to offset taxable income in prior years.

### ***Nine Months Ended September 30, 2011 Compared to the Nine Months Ended September 30, 2010***

*Revenues.* Revenues were \$46.5 million and \$95.2 million for the nine months ended September 30, 2011 and 2010, respectively, representing a decrease of \$48.7 million, or 51.1%. Wireless revenues decreased \$46.6 million, or 53.8%, primarily due to continued lower sales of our base business connection manager products to our carrier customers of \$38.9 million and PC OEM customers of \$5.5 million and a large device solutions sale in the second quarter of 2010 and not repeated in 2011 of \$2.2 million. Productivity & Graphics revenues decreased \$2.0 million, or 23.6% due to low consumer spending and moving toward a more internal distribution model. Corporate/Other sales decreased \$0.1 million as we have de-emphasized this business.

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Due to the introduction and market acceptance of mobile hotspot devices, tablets and smartphones capable of functioning as a WWAN hotspot, our core connection management products are experiencing lower demand in our North American marketplace. While we have launched new wireless products that address this technology shift, they are new to the market and have not yet been adopted and thus there is a material uncertainty regarding our future wireless revenues.

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*Cost of revenues.* Cost of revenues was \$11.0 million and \$11.4 million for the nine months ended September 30, 2011 and 2010, representing a decrease of \$0.4 million, or 3.8%. Direct product costs increased \$0.4 million primarily due to costs associated with the start-up of our new backup and messaging services. Amortization of intangibles decreased from \$4.5 million to \$3.8 million, or \$0.7 million. Stock-based compensation expense decreased from \$0.1 million to nearly zero, or \$0.1 million. No future amortization of intangibles is anticipated as these assets have been fully impaired.

*Gross profit.* Gross profit was \$35.5 million, or 76.3% of revenues for the nine months ended September 30, 2011, a decrease of \$48.3 million, or 57.6%, from \$83.8 million, or 88.0% of revenues for the nine months ended September 30, 2010. The 11.7 percentage point decrease was primarily due to lower product margins of 8.4 points as a result of the lower revenues not absorbing our fixed costs and our datacenter and start-up costs associated with our backup and messaging products. Amortization of intangibles as a percentage of revenues decreased 3.3 points primarily due to the lower revenues.

*Selling and marketing.* Selling and marketing expenses were \$21.9 million and \$22.0 million for the nine months ended September 30, 2011 and 2010, respectively, representing a decrease of \$0.1 million, or 0.5%. There were increases in personnel costs of \$0.2 million, higher travel of \$0.2 million and higher costs for outside services of \$0.1 million. These cost increases were offset by lower stock-based compensation expense that decreased from \$2.3 million to \$1.8 million, or \$0.5 million, and the amortization of intangibles that decreased from \$2.2 million to \$2.1 million, or \$0.1 million. No future amortization of intangibles is anticipated as these assets have been fully impaired.

*Research and development.* Research and development expenses were \$33.7 million and \$31.2 million for the nine months ended September 30, 2011 and 2010, respectively, representing an increase of \$2.5 million, or 8.0%. This increase was primarily due to additional headcount of \$2.6 million to support our new product initiatives and higher supplies related to these new projects of \$0.5 million. Amortization of intangibles increased from zero to \$0.2 million. Stock-based compensation expense decreased from \$1.9 million to \$1.1 million, or \$0.8 million. No future amortization of intangibles is anticipated as these assets have been fully impaired.

*General and administrative.* General and administrative expenses were \$20.0 million and \$18.1 million for the nine months ended September 30, 2011 and 2010, respectively, representing an increase of \$1.9 million, or 10.8%. This increase was primarily due to increased space and occupancy costs and depreciation/amortization associated with facility expansions of \$2.0 million and legal expenses of \$0.7 million, partially offset by lower personnel costs of \$0.2 million. Stock-based compensation expense decreased from \$4.1 million to \$3.5 million, or \$0.6 million.

*Restructuring expenses.* Restructuring expenses of \$1.0 million for the nine months ended September 30, 2011 were related to the Chicago facility shutdown of \$0.8 million and other one-time employee termination benefits of \$0.2 million. There were no restructuring expenses in 2010. As a result of a Restructuring Plan approved on October 18, 2011, we anticipate additional restructuring expenses in the range of \$2.0-2.5 million to be recorded during the fourth quarter of 2011.

*Goodwill and long-lived asset impairment.* Goodwill and long-lived asset impairment charges of \$112.9 million for the nine months ended September 30, 2011 were related to goodwill of \$94.2 million, intangible assets of \$13.4 million, and fixed assets of \$5.3 million. There were no impairment charges in 2010.

*Income tax provision.* We recorded an income tax benefit of \$3.9 million and a tax provision of \$6.0 million for the nine months ended September 30, 2011 and 2010, respectively. The effective tax rate for the nine months ended September 30, 2011 was impacted by the valuation allowance and carryback of losses to offset taxable income in prior years.

## **Liquidity and Capital Resources**

At September 30, 2011, we had \$54.1 million in cash and cash equivalents and short-term investments and \$60.6 million of working capital. Capital expenditures increased \$8.9 million for the nine months ended September 30, 2011 versus the nine months ended September 30, 2010 as we expanded our Aliso Viejo datacenter and built out our new Pittsburgh facility and datacenter. We anticipate a small amount of capital expenditures in the fourth quarter. We believe that our existing cash and cash equivalents and short-term investment balances will be sufficient to finance our working capital and capital expenditure requirements through at least the next twelve months. We may require additional funds to support our working capital requirements or for other purposes and may seek to raise additional funds through public or private equity or debt financing or from other sources. If additional financing is needed, we cannot assure that such financing will be available to us at commercially reasonable terms or at all.



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### Operating activities

Net cash used by operating activities was \$5.8 million for the nine months ended September 30, 2011. The primary uses of operating cash were our net loss (excluding asset impairment) of \$37.2 million, the increase of income tax receivables of \$5.2 million and other net assets increasing by \$0.8 million. These uses were partially offset with cash provided by accounts receivable of \$20.4 million, non-cash expenses including depreciation and amortization of \$9.1 million, stock-based compensation of \$5.1 million, lease incentives of \$2.2 million and other account adjustments of \$0.6 million.

Net cash provided by operating activities was \$15.4 million for the nine months ended September 30, 2010. Our net cash provided by operating activities resulted from net income of \$6.6 million adjusted for non-cash expenses including depreciation and amortization of \$8.9 million, stock-based compensation of \$7.0 million, other non-cash expenses of \$0.4 million, and increases of current liabilities net of other assets of \$1.7 million. The primary use of cash affecting operating cash flow was an increase in accounts receivable of \$9.0 million and an increase of inventory of \$0.2 million.

### Investing activities

During the nine months ended September 30, 2011, we were provided cash of \$7.6 million using our short-term investments of \$20.7 million partially offset by investing in capital expenditures of \$13.1 million to expand our Aliso Viejo datacenter and build out our new Pittsburgh facility and datacenter.

During the nine months ended September 30, 2010, we used \$18.7 million in investing activities due to investing in short-term investments of \$14.0 million, capital expenditures for leasehold improvements, business systems, and other computer equipment of \$4.2 million, and acquisitions of \$0.5 million.

### Financing activities

We received \$0.4 million in cash during the nine months ended September 30, 2011 from the stock sale for the employee stock purchase plan.

We received \$1.0 million in cash during the nine months ended September 30, 2010 from the exercise of stock options of \$0.3 million and for tax benefits from stock-based compensation of \$0.7 million.

### Contractual obligations and commercial commitments

As of September 30, 2011 we had no debt. The following table summarizes our contractual obligations as of September 30, 2011 (in thousands):

| Contractual obligations:    | Payments due by period |                 |                 |                 |                   |
|-----------------------------|------------------------|-----------------|-----------------|-----------------|-------------------|
|                             | Total                  | 1 year or less  | 1-3 years       | 3-5 years       | More than 5 years |
| Operating Lease Obligations | \$ 20,538              | \$ 2,742        | \$ 5,455        | \$ 4,625        | \$ 7,716          |
| Purchase Obligations        | 658                    | 658             |                 |                 |                   |
| <b>Total</b>                | <b>\$ 21,196</b>       | <b>\$ 3,400</b> | <b>\$ 5,455</b> | <b>\$ 4,625</b> | <b>\$ 7,716</b>   |

During our normal course of business, we have made certain indemnities, commitments and guarantees under which we may be required to make payments in relation to certain transactions. These include: intellectual property indemnities to our customers and licensees in connection with the use, sale and/or license of our products; indemnities to various lessors in connection with facility leases for certain claims arising from such facility or lease; indemnities to vendors and service providers pertaining to claims based on the negligence or willful misconduct; indemnities involving the accuracy of representations and warranties in certain contracts; and indemnities to directors and officers of the Company to the maximum extent permitted under the laws of the State of Delaware. We may also issue a guarantee in the form of a standby letter of credit as security for contingent liabilities under certain customer contracts. The duration of these indemnities, commitments and guarantees varies, and in certain cases, may be indefinite. The majority of these indemnities, commitments and guarantees may not provide for any limitation of the maximum potential for future payments we could be obligated to make. We have not recorded any liability for these indemnities, commitments and guarantees in the accompanying consolidated balance sheets.

*Real Property Leases*

Our corporate headquarters, including our principal administrative, sales and marketing, customer support and research and development facility, is located in Aliso Viejo, California, where we currently lease and occupy approximately 52,700 square feet of space pursuant to leases that expire on May 31, 2016 and January 31, 2022. We lease approximately 55,600 square feet in Pittsburgh, Pennsylvania under a lease that expires December 31, 2021. We lease approximately 21,000 square feet in Mountain View, California

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under a lease that expires February 28, 2014. We lease approximately 15,300 square feet in Watsonville, California under a lease that expires September 30, 2018. Internationally, we lease space in Stockholm, Sweden; Belgrade, Serbia; and Vancouver, Canada. These leases are for one to six-year terms.

### **Critical Accounting Policies and Estimates**

Our discussion and analysis of results of operations, financial condition and liquidity are based upon our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America. The preparation of these financial statements requires us to make estimates and judgments 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 period. We base our estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances. Actual results may materially differ from these estimates under different assumptions or conditions. On an on-going basis, we review our estimates to ensure that the estimates appropriately reflect changes in our business or new information as it becomes available.

We believe the following critical accounting policies affect our more significant estimates and assumptions used in the preparation of our consolidated financial statements:

#### *Revenue Recognition*

We currently report our net revenues under two operating groups: Wireless and Productivity & Graphics. Within each of these groups software revenue is recognized based on the customer and contract type. We recognize revenue when persuasive evidence of an arrangement exists, delivery has occurred, the price is fixed and determinable, and collectability is probable as required by FASB ASC Topic No. 985-605, Software-Revenue Recognition. We recognize revenues from sales of our software to our customers or end users as completed products are shipped and title passes; or from royalties generated as authorized customers duplicate our software, if the other requirements are met. If the requirements are not met at the date of shipment, revenue is not recognized until these elements are known or resolved. For Wireless sales, returns from customers are limited to defective goods or goods shipped in error. Historically, customer returns have not exceeded the very nominal estimates and reserves. We also provide some technical support to our customers. Such costs have historically been insignificant.

We have a few multiple element agreements for which we have 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). As of January 1, 2011, we adopted ASU No. 2009-13, *Revenue Recognition (Topic 605): Multiple-Deliverable Revenue Arrangements* which amends revenue recognition guidance for arrangements with multiple deliverables. The new guidance eliminated the residual method of revenue recognition and allows the use of management's best estimate of selling price for individual elements of an arrangement when vendor specific objective evidence (VSOE), vendor objective evidence (VOE) or third-party evidence (TPE) is unavailable. For most of our multiple element agreements, VSOE for all contract elements is used and the timing of the individual element revenue streams is determined and recognized as delivered.

For Productivity & Graphics sales, management 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. Certain revenues are booked net of revenue sharing payments. Sales directly to end-users are recognized upon shipment. End users have a thirty day right of return, but such returns are reasonably estimable and have historically been immaterial. We also provide technical support to our customers. Such costs have historically been insignificant.

#### *Sales Incentives*

For our Productivity & Graphics sales, 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 as required by FASB ASC Topic No. 985-605, Software-Revenue Recognition. We use historical redemption rates to estimate the cost of customer incentives. Total sales incentives were \$0.5 million for both nine months ended September 30, 2011 and 2010.

#### *Accounts Receivable and Allowance for Doubtful Accounts*

We sell our products worldwide. We perform ongoing credit evaluations of our customers and adjust credit limits based upon payment history, the customer's current credit worthiness and various other factors, as determined by our review of their current credit information. We continuously monitor collections and payments from our customers. We estimate credit losses and maintain an allowance for doubtful accounts reserve based upon these estimates. While such credit losses have historically been within our estimated reserves, we cannot guarantee that we

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will continue to experience the same credit loss rates that we have in the past. If not, this could have an adverse effect on our consolidated financial statements.

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### *In-Process Research and Development*

In 2009, we capitalized \$1.0 million of IPR&D costs related to our acquisition of Core Mobility in accordance with accounting standards that became effective in 2009. This IPR&D project was completed during the fourth quarter of 2010 and amortization had commenced at that time.

The fair value of the IPR&D was determined using the discounted cash flow approach. The expected future cash flows were estimated and discounted to their net present values at an appropriate risk-adjusted rate of return. Significant factors considered in the calculation of the rate of return were the weighted average cost of capital and return on assets, as well as the risks inherent in the development process, including the likelihood of achieving technological success and market acceptance. Future cash flows were estimated based on forecasted revenue and costs, taking into account the expected product life cycle, market penetration and growth rates.

As a result of our goodwill and long-lived asset impairment analysis, we have fully impaired this asset as of September 30, 2011. As such, there will be no future amortization expense recorded for these impaired assets.

### *Capitalized Software and Amortization*

We capitalize internally developed software and software purchased from third parties if the related software product under development has reached technological feasibility or if there are alternative future uses for the purchased software as required by FASB ASC Topic No. 985-20, Software-Costs of Software to be Sold, Leased, or Marketed. These costs are amortized on a product-by-product basis, typically over an estimated life of five to seven years, using the larger of the amount calculated using the straight-line method or the amount calculated using the ratio between current period gross revenues and the total of current period gross revenues and estimated future gross revenues. At each balance sheet date, we evaluate on a product-by-product basis the unamortized capitalized cost of computer software compared to the net realizable value of that product. The amount by which the unamortized capitalized costs of a computer software product exceed its net realizable value is written off.

As a result of our goodwill and long-lived asset impairment analysis, we have fully impaired these assets as of September 30, 2011. As such, there will be no future amortization expense recorded for these impaired assets.

### *Intangible Assets and Amortization*

Amortization expense related to other intangibles acquired in previous acquisitions is calculated on a straight line basis over various useful lives.

As a result of our goodwill and long-lived asset impairment analysis, we have fully impaired these assets as of September 30, 2011. As such, there will be no future amortization expense recorded for these impaired assets.

### *Goodwill*

The Company accounts for goodwill and other intangible assets in accordance with FASB ASC Topic No. 350, Intangibles-Goodwill and Other, which requires that goodwill and other identifiable intangible assets with indefinite useful lives be tested for impairment at least annually. The Company tests goodwill and intangible assets for impairment in December of each year, or more frequently if events and circumstances warrant. These assets are impaired if the Company determines that their carrying values may not be recoverable based on an assessment of certain events or changes in circumstances:

a determination that the carrying value of such assets cannot be recovered through undiscounted cash flows;

loss of legal ownership or title to the assets;

significant changes in our strategic business objectives and utilization of the assets; or

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the impact of significant negative industry or economic trends.

If the assets are considered to be impaired, the Company recognizes the amount by which the carrying value of the assets exceeds the fair value of the assets as an impairment loss.

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The goodwill impairment test is a two-step process. The first step compares the Company's fair value to its net book value. If the fair value is less than the net book value, the second step of the test compares the implied fair value of the Company's goodwill to its carrying amount. If the carrying amount of goodwill exceeds its implied fair value, the Company would recognize an impairment loss equal to that excess amount.

The fair value of a reporting unit refers to the price that would be received to sell the unit as a whole in an orderly transaction between market participants at the measurement date. Quoted market prices in active markets are the best evidence of fair value and shall be used as the basis for the measurement, if available. However, the market price of an individual equity security (and thus the market capitalization of a reporting unit with publicly traded equity securities) may not be representative of the fair value of the reporting unit as a whole. Substantial value may arise from the ability to take advantage of synergies and other benefits that flow from control over another entity. Consequently, measuring the fair value of a collection of assets and liabilities that operate together in a controlled entity is different from measuring the fair value of that entity's individual equity securities. An acquiring entity often is willing to pay more for equity securities that gives it a controlling interest than an investor would pay for a number of equity securities representing less than a controlling interest. That control premium may cause the fair value of a reporting unit to exceed its market capitalization. The quoted market price of an individual equity security, therefore, need not be the sole measurement basis of the fair value of a reporting unit.

At December 31, 2010, the Company estimated the fair value in Step 1 based on the income approach which included discounted cash flows as well as a market approach that utilized the Company's earnings and revenue multiples. The Company's discounted cash flows required management judgment with respect to forecasted revenues, launch of new products, operating expenses, working capital and the selection and use of an appropriate discount rate. The Company's assessment resulted in a fair value that was marginally greater than the Company's carrying values for the Productivity & Graphics operating unit and was significantly greater than the Company's carrying values for the Wireless operating unit at December 31, 2010. In accordance with the authoritative literature, the second step of the impairment test was not required to be performed and no impairment of goodwill was recorded as of December 31, 2010.

At June 30, 2011, the Company concluded that a decline in its stock price and market capitalization was not representative of the fair value of the reporting unit as a whole. The goodwill impairment test should be based on an other-than-temporary decline. The Company believed that it was more likely than not that the fair value of the Company's two reporting units had not declined below the reporting unit's carrying amount because there had been temporary declines in (1) the stock price, (2) revenues due to a technology shift in our marketplace resulting in our core connection management products experiencing lower demand in certain markets and (3) earnings as we continued to invest heavily in R&D to bring new products to market. There are several new products that we expected to launch during the second half of 2011 that would address the technology shift in the marketplace. As such, the Company expected these new products, should they be successful, to result in improved revenues and profitability during the second half of 2011.

At June 30, 2011, the Company stated that if its revenues, profitability, and stock price did not improve in the third and/or fourth quarter of 2011, we would more likely than not have to perform Step 1 of the impairment test. The triggering events we monitored were revenues, new product launches, profitability, and stock price.

During the period ended September 30, 2011, the Company concluded that a decline in its stock price and market capitalization was representative of the fair value of the reporting unit as a whole. The triggering events that led us to this conclusion were:

Revenues - declined for the third consecutive quarter.

New product launches - although we are in trials for several of our new products, as of September 30, 2011 we have not realized any revenues from these new products.

Profitability - declined for the third consecutive quarter.

Stock price - has remained at depressed prices.

As such, the Company performed Step 1 of the impairment test. For both reporting units, fair value was determined by an average of a market approach and a discounted cash flow method. For the Wireless unit, the concluded fair value as of September 30, 2011 was approximately \$78.7 million and the carrying value was \$172.6 million which failed Step 1 and triggered Step 2. For the Productivity & Graphics unit, the concluded

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fair value as of September 30, 2011 was approximately \$5.7 million and the carrying value was \$16.8 million which failed Step 1 and triggered Step 2. For Step 2, the implied fair value of goodwill was measured (as the excess of the fair value of a reporting unit over the amounts assigned to its assets and liabilities, including any unrecognized intangible assets), and compared to the carrying value of goodwill. The inputs measured at fair value used in this valuation methodology were considered Level 3 in the three-tier value hierarchy per FASB ASC Topic No. 820, Fair Value Measurements and Disclosures. The excess (if any) of the carrying value of goodwill was compared to the implied fair value of goodwill and resulted in an impairment loss of \$94.2 million in the fiscal quarter ended September 30, 2011.

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The following table sets forth the change in the carrying amount of goodwill balances as of September 30, 2011 and December 31, 2010 (in thousands):

|                                  | Wireless  | Productivity &<br>Graphics | Total     |
|----------------------------------|-----------|----------------------------|-----------|
| Balance as of December 31, 2010  | \$ 84,616 | \$ 9,615                   | \$ 94,231 |
| Accumulated impairment losses    |           |                            |           |
| Balance as of June 30, 2011      | 84,616    | 9,615                      | 94,231    |
| Impairment losses                | (84,616)  | (9,615)                    | (94,231)  |
| Balance as of September 30, 2011 | \$        | \$                         | \$        |

### Impairment of Long-Lived Assets

The Company assesses potential impairment to its long-lived assets as required by FASB ASC Topic No. 360, Property, Plant, and Equipment, when there is evidence that events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. An impairment loss is recognized when the carrying amount of the long-lived assets is not recoverable if it exceeds the sum of the undiscounted cash flows expected to result from the use and eventual disposition of the asset. Any required impairment loss is measured as the amount by which the carrying amount of a long-lived asset exceeds its fair value and is recorded as a reduction in the carrying value of the related asset and a charge to operating results.

As a result of the triggering events described above in our goodwill impairment analysis, the Company reviewed its long-lived assets for recoverability. As a result of this analysis, the Company recognized a long-lived asset impairment charge of \$18.7 million in the fiscal quarter ended September 30, 2011 which was allocated pro-rata to the intangible assets of \$13.4 million and \$5.3 million to equipment and improvements, primarily related to our leasehold improvements. The inputs measured at fair value used in this valuation methodology were considered Level 3 in the three-tier value hierarchy per FASB ASC Topic No. 820, Fair Value Measurements and Disclosures.

The following table sets forth the change in the carrying amount of intangible asset balances as of September 30, 2011 and December 31, 2010 (in thousands):

|                                  | Wireless  | Productivity &<br>Graphics | Total     |
|----------------------------------|-----------|----------------------------|-----------|
| Balance as of December 31, 2010  | \$ 17,136 | \$ 2,323                   | \$ 19,459 |
| Accumulated amortization         | (3,539)   | (520)                      | (4,059)   |
| Accumulated impairment losses    |           |                            |           |
| Balance as of June 30, 2011      | 13,597    | 1,803                      | 15,400    |
| Amortization                     | (1,767)   | (258)                      | (2,025)   |
| Impairment losses                | (11,830)  | (1,545)                    | (13,375)  |
| Balance as of September 30, 2011 | \$        | \$                         | \$        |

### Income Taxes

We account for income taxes as required by FASB ASC Topic No. 740, Income Taxes. This statement requires the recognition of deferred tax assets and liabilities for the future consequences of events that have been recognized in our 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

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tax bases of our assets and liabilities result in a deferred tax asset, we are required to evaluate 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 the entire deferred tax asset will not be realized. The Company's net deferred tax assets were reduced by a tax valuation allowance at September 30, 2011. Management evaluated the positive and negative evidence in determining the realizability of the net deferred tax assets at September 30, 2011 and concluded it is not more likely than not that the Company should realize its net deferred tax assets through future operating results and the reversal of taxable temporary differences.

### *Stock-Based Compensation*

The Company accounts for all stock-based payment awards made to employees and directors based on their fair values and recognized as compensation expense over the vesting period using the straight-line method over the requisite service period for each award as required by FASB ASC Topic No. 718, Compensation-Stock Compensation.

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### **Item 3. Quantitative and Qualitative Disclosures About Market Risk.**

#### *Interest Rate Risk*

Our financial instruments include cash and cash equivalents and short-term investments. At September 30, 2011, the carrying values of our financial instruments approximated fair values based on current market prices and rates.

#### *Foreign Currency Risk*

While a majority of our business is denominated in U.S. dollars, we do invoice in foreign currencies. For the three months ended September 30, 2011 and 2010, our revenues denominated in foreign currencies were \$0.2 million and \$0.4 million, respectively. For the nine months ended September 30, 2011 and 2010, our revenues denominated in foreign currencies were \$1.0 million and \$1.2 million, respectively. Fluctuations in the rate of exchange between the U.S. dollar and certain other currencies may affect our results of operations and period-to-period comparisons of our operating results. We do not currently engage in hedging or similar transactions to reduce these risks. The operational expenses of our foreign entities reduce the currency exposure we have because our foreign currency revenues are offset in part by expenses payable in foreign currencies. As such, we do not believe we have a material exposure to foreign currency rate fluctuations at this time.

### **Item 4. Controls and Procedures.**

#### *Evaluation of disclosure controls and procedures*

We conducted an evaluation under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Rules 13a-15(e) under the Securities Exchange Act of 1934 ( Exchange Act )) as of September 30, 2011. Based upon that evaluation, our Chief Executive Officer and Chief Financial Officer have determined that as of September 30, 2011, our disclosure controls and procedures were effective to ensure that the information required to be disclosed in our Exchange Act reports is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms, and that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure. In designing and evaluating the disclosure controls and procedures, our management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives, and our management necessarily is required to apply its judgment in evaluating the cost-benefit relationship of possible controls and procedures.

#### *Management's responsibility for financial statements*

Our management is responsible for the integrity and objectivity of all information presented in this report. The consolidated financial statements were prepared in conformity with accounting principles generally accepted in the United States of America and include amounts based on management's best estimates and judgments. Management believes the consolidated financial statements fairly reflect the form and substance of transactions and that the financial statements fairly represent the Company's financial position and results of operations for the periods and as of the dates stated therein.

The Audit Committee of the Board of Directors, which is composed solely of independent directors, meets regularly with our independent registered public accounting firm, SingerLewak LLP, and representatives of management to review accounting, financial reporting, internal control and audit matters, as well as the nature and extent of the audit effort. The Audit Committee is responsible for the engagement of the independent auditors. The independent auditors have free access to the Audit Committee.

#### *Changes in internal control over financial reporting*

There have been no changes in our internal controls over financial reporting during the quarter ended September 30, 2011 that have materially affected, or is reasonably likely to materially affect, our internal controls over financial reporting.

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### **PART II. OTHER INFORMATION**

#### **Item 1. Legal Proceedings.**

On June 29, 2011, a complaint was filed in the U.S. District Court for the Central District of California against us and certain of our current and past officers and directors on behalf of certain purchasers of our common stock. The complaint has been brought as a purported stockholder class action, and, in general, includes allegations that we and certain of our officers and directors violated federal securities laws by making materially false and misleading statements regarding our business prospects and financial results, thereby artificially inflating the price of our common stock. The plaintiff is seeking unspecified monetary damages and other relief. On August 29, 2011, two prospective lead plaintiffs filed motions for appointment of lead plaintiff and for appointment of lead counsel. On October 17, 2011, the court appointed the two prospective lead plaintiffs as co-lead plaintiffs and their respective counsel as co-lead counsel. We expect the co-lead plaintiffs to file an amended complaint. We intend to vigorously defend against the claims advanced, and intend to file a motion to dismiss the amended complaint.

On August 11, 2011, a shareholder derivative complaint was filed in the Superior Court of California for the County of Orange against the Company's directors and certain of its executive officers. Thereafter, two additional similar complaints, also styled as shareholder derivative actions, were filed in state court (collectively, the "State Derivative Actions"). On September 12, 2011, a shareholder derivative complaint was filed in the U.S. District Court for the Central District of California against certain of the officers and directors named in the State Derivative Actions but also against additional officers of the company (the "Federal Derivative Action"). Collectively, the State Derivative Actions and the Federal Derivative Action are referred to as the "Derivative Actions." The complaints in the Derivative Actions allege breaches of fiduciary duties by the defendants and other violations of state law. In general, the complaints in the Derivative Actions allege that the Company's directors and certain of its officers caused or allowed for the dissemination of materially false and misleading statements regarding our business prospects and financial results, thereby artificially inflating the price of our common stock. Plaintiffs in the Derivative Actions seek unspecified monetary damages and other relief, including reforms and improvements to the Company's corporate governance and internal procedures. We intend to vigorously defend against the claims advanced in the Derivative Actions, and intend to file demurrers and/or motion(s) to dismiss the complaints in the Derivative Actions.

The Company is and may become involved in various other legal proceedings arising from its business activities. While management does not believe the ultimate disposition of these matters will have a material adverse impact on the Company's consolidated results of operations, cash flows or financial position, litigation is inherently unpredictable, and depending on the nature and timing of these proceedings, an unfavorable resolution could materially affect the Company's future consolidated results of operations, cash flows or financial position in a particular period.

#### **Item 1A. Risk Factors**

Our future operating results are highly uncertain. Before deciding to invest in our common stock or to maintain or increase your investment, you should carefully consider the risks described below, in addition to the other information contained in this report and in our other filings with the SEC, including our reports on Forms 10-K, 10-Q and 8-K. The risks and uncertainties described below are not the only ones we face. Additional risks and uncertainties not presently known to us or that we currently deem immaterial may also affect our business operations. If any of these risks actually occur, that could seriously harm our business, financial condition or results of operations. In that event, the market price for our common stock could decline and you may lose all or part of your investment.

***Our revenues currently depend on a small number of products and customers, so our revenue and operating results are vulnerable to shifts in demand and may continue to decline.***

A substantial majority of our revenue is derived from sales of our wireless connectivity and security software products. Revenues from sales of our core connection management product have recently declined and may continue to decline in future quarters due to shifts in technology, particularly the inclusion of connectivity in the operating system of new devices and decline in sales of USB hardware by wireless carriers. We have developed new products which address these shifts in technology, but currently have not realized any revenues from these products. There can be no guarantee that our revenues will stabilize or increase in future quarters.

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In addition, our strategy is to continue to introduce and market new products, but these efforts are not likely to reduce the extent to which our revenues are dependent on a small number of products. Rapid shifts in the markets for these products and consumer habits, changes in demand by end-users and changes in underlying technology could cause material and rapid changes in our revenues and profitability. Factors which could affect demand for our products include the rate of adoption of the 4G networking standard by wireless carriers and handset manufacturers, and changes in consumer demand for PC networking due to the adoption of Smartphones and tablet computing. If our products fail to remain current with and useful to new and emerging markets, our business, financial condition and results of operations would be materially and adversely affected.

We also derive a significant portion of our revenues from a few vertical markets, such as wireless carriers and handset manufacturers. In order to sustain and grow our business, we must continue to sell our software products into these vertical markets. Shifts in the dynamics of these vertical markets, such as new product introductions by our competitors, could materially harm our results of operations, financial condition and prospects. To increase our sales outside our core vertical markets, for example to large enterprises, requires us to devote time and resources to hire and train sales employees familiar with those industries. Even if we are successful in hiring and training sales teams, customers in other vertical markets may not need or sufficiently value our current products or new product introductions.

In addition, because we sell primarily to large carriers and OEMs, there are a limited number of actual and potential customers for our products, resulting in customer concentration for sales of our products and services. For the nine months ended September 30, 2011, three customers comprised of 23.5%, 19.6% and 11.9% of our total revenues. Because of our customer concentration, our largest customers may have significant pricing power over us. Furthermore, a substantial decrease in sales to any of our largest customers could materially affect our revenues and profitability. Additionally, these customers are not the end-users of our products. If any of these customers' efforts to market their products which incorporate our software are unsuccessful in the marketplace, our revenues and profitability could be adversely affected.

***Our quarterly revenues and operating results are difficult to predict and could fall below analyst or investor expectations, which could cause the price of our common stock to fall.***

Our quarterly revenues and operating results have fluctuated significantly in the past and may continue to vary from quarter to quarter due to a number of factors, many of which are not within our control. If our operating results do not meet the expectations of securities analysts or investors, our stock price may decline. Fluctuations in our operating results may be due to a number of factors, including the following:

the gain or loss of a key customer;

the size and timing of orders from and shipments to our major customers;

the size and timing of any return product requests for our products;

our ability to maintain or increase gross margins;

variations in our sales channels or the mix of our product sales;

our ability to anticipate market needs and to identify, develop, complete, introduce, market and produce new products and technologies in a timely manner to address those needs;

the availability and pricing of competing products and technologies and the resulting effect on sales and pricing of our products;

acquisitions;

the effect of new and emerging technologies;

the timing of acceptance of new mobile services by users of our customers' services;

deferrals of orders by our customers in anticipation of new products, applications, product enhancements or operating systems; and

general economic and market conditions.

We have difficulty predicting the volume and timing of orders. In any given quarter, our sales have involved, and we expect will continue to involve, large financial commitments from a relatively small number of customers. As a result, the cancellation or deferral of even a small number of orders would reduce our revenues, which would adversely affect our quarterly financial performance. Also, we have often booked a large amount of our sales in the last month of the quarter and often in the last week of that month. Accordingly, delays in the closing of sales near the end of a quarter could cause quarterly revenues to fall substantially short of anticipated levels. Significant sales may also occur earlier than expected, which could cause operating results for later quarters to compare unfavorably with operating results from earlier quarters.

A large portion of our operating expenses, including rent, depreciation and amortization is fixed and difficult to reduce or change. Accordingly, if our total revenue does not meet our expectations, we may not be able to adjust our expenses quickly enough to compensate for the shortfall in revenue. In that event, our business, financial condition and results of operations would be materially and adversely affected.

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Due to all of the foregoing factors, and the other risks discussed in this report, you should not rely on quarter-to-quarter comparisons of our operating results as an indication of future performance.

***We may have further impairments of long-lived assets if our business does not improve and our stock price declines which could cause a material adverse effect on our financial condition and results of operations.***

The Company assesses potential impairment to its long-lived assets as required by FASB ASC Topic No. 360, Property, Plant, and Equipment, when there is evidence that events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. An impairment loss is recognized when the carrying amount of the long-lived assets is not recoverable if it exceeds the sum of the undiscounted cash flows expected to result from the use and eventual disposition of the asset. Any required impairment loss is measured as the amount by which the carrying amount of a long-lived asset exceeds its fair value and is recorded as a reduction in the carrying value of the related asset and a charge to operating results. For the quarter ended September 30, 2011, we recorded a charge for impairment of long-lived assets of \$18.7 million (\$13.4 million on intangible assets and \$5.3 million on fixed assets) due, in part, to continued declines in our revenues and profitability and our continued depressed stock price. In future quarters, we may be required to take further charges for impairment of fixed assets, which could have a material adverse effect on our financial condition and results of operations.

***Competition within our target markets is intense and includes numerous established competitors and new entrants, which could negatively affect our revenues and results of operations.***

We operate in markets that are extremely competitive and subject to rapid changes in technology. A number of established software and hardware companies, such as Microsoft Corporation, Google Inc. and Apple Inc. pose a significant competitive threat to us because their handset operating systems and phones may include some capabilities now provided by certain of our OEM and retail software products. If handset manufacturers and carriers are satisfied relying on the capabilities of systems using Windows, Android or iPhone OS, or other hardware or operating systems, sales of our products are likely to decline. In addition, because there are low barriers to entry into the software markets in which we participate and may participate in the future, we expect significant competition to continue from both established and emerging software companies in the future, both domestic and international. In fact, our growth opportunities in new product markets could be limited to the extent established and emerging software companies enter or have entered those markets. Furthermore, our existing and potential OEM customers may acquire or develop products that compete directly with our products.

Many of our other current and prospective competitors have significantly greater financial, marketing, service, support, technical and other resources than we do. As a result, they may be able to adapt more quickly than we to new or emerging technologies and changes in customer requirements or to devote greater resources to the promotion and sale of their products. Announcements of competing products by competitors could result in the cancellation of orders by customers in anticipation of the introduction of such new products. In addition, some of our competitors currently make complementary products that are sold separately. Such competitors could decide to enhance their competitive position by bundling their products to attract customers seeking integrated, cost-effective software applications. Some competitors have a retail emphasis and offer OEM products with a reduced set of features. The opportunity for retail upgrade sales may induce these and other competitors to make OEM products available at their own cost or even at a loss. We also expect competition to increase as a result of software industry consolidations, which may lead to the creation of additional large and well-financed competitors. Increased competition is likely to result in price reductions, fewer customer orders, reduced margins and loss of market share.

***Technology and customer needs change rapidly in our market, which could render our products obsolete and negatively affect our business, financial condition and results of operations.***

Our success depends on our ability to anticipate and adapt to changes in technology and industry standards. We will also need to continue to develop and introduce new and enhanced products to meet our target markets' changing demands, keep up with evolving industry standards, including changes in the Microsoft and Google operating systems with which our products are designed to be compatible, and to promote those products successfully. The communications and utilities software markets in which we operate are characterized by rapid technological change, changing customer needs, frequent new product introductions, evolving industry standards and short product life cycles. Any of these factors could render our existing products obsolete and unmarketable. In addition, new products and product enhancements can require long development and testing periods as a result of the complexities inherent in today's computing environments and the performance demanded by customers and called for by evolving wireless networking technologies. If our target markets do not develop as we anticipate, our products do not gain widespread acceptance in these markets, or we are unable to develop new versions of our software products that can operate on future wireless networks and PC and mobile device operating systems and interoperate with other popular applications, our business, financial condition and results of operations could be materially and adversely affected.



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***We are entering new, emerging markets in which we have limited experience; if these markets do not develop or we are unable to otherwise succeed in them, our revenues will suffer and the price of our common stock will likely decline.***

Our recent and planned product introductions to support new higher speed networking and 4G technologies such as HSPA+, LTE and WiMAX network protocols have allowed us to enter new markets. A viable market for these products may not develop or be sustainable, and we may face intense competition in these markets. In addition, our success in these markets depends on our carrier customers' ability to successfully introduce new mobile services enabled by our products and our ability to broaden our carrier customer base, which we believe will be difficult and time-consuming. If the expected benefits from entering new markets do not materialize, our revenues will suffer and the price of our common stock would likely decline. In addition, to the extent we enter new markets through acquisitions of companies or technologies, our financial condition could be harmed or our stockholders could suffer dilution without a corresponding benefit to our company if we do not realize expected benefits of entering such new markets.

***If the adoption of and investments in new technologies and services grows more slowly than anticipated in our product planning and development, our operating results, financial condition and prospects may be negatively affected.***

If the adoption of and investments in new networking and 4G technologies and services does not grow or grows more slowly than anticipated, we will not obtain the anticipated returns from our planning and development investments. For example, our Device Management Suite of products allows our customers to update mobile devices from a home office and incorporates technology that provides a mechanism to allow for efficient firmware updates for mobile devices. In addition, we have introduced new high-speed networking and 4G products, but the pace of the market introduction of such technologies is uncertain. Future sales and any future profits from these and related products are substantially dependent upon the acceptance and use of these new technologies, and on the continued adoption and use of mobile data services by end-users.

Many of our customers and other communications service providers have made and continue to make major investments in next generation networks that are intended to support more complex applications. If communications service providers delay their deployment of networks or fail to deploy such networks successfully, demand for our products could decline, which would adversely affect our revenues. Also, to the extent we devote substantial resources and incur significant expenses to enable our products to be interoperable with new networks that have failed or have been delayed or not deployed, our operating results, financial condition and prospects may be negatively affected.

***If we are unable to retain key personnel, the loss of their services could materially and adversely affect our business, financial condition and results of operations.***

Our future performance depends in significant part upon the continued service of our senior management and other key technical and consulting personnel. We do not have employment agreements with our key employees that govern the length of their service. The loss of the services of our key employees would materially and adversely affect our business, financial condition and results of operations. Our future success also depends on our ability to continue to attract, retain and motivate qualified personnel, particularly highly skilled engineers involved in the ongoing research and development required to develop and enhance our products. Competition for these employees remains high and employee retention is a common problem in our industry. Our inability to attract and retain the highly trained technical personnel that are essential to our product development, marketing, service and support teams may limit the rate at which we can generate revenue, develop new products or product enhancements and generally would have an adverse effect on our business, financial condition and results of operations.

***If we fail to continue to establish and maintain strategic relationships with mobile device manufacturers, market acceptance of our products and our profitability may suffer.***

Most of our strategic relationships with mobile device manufacturers are not subject to written contract, but rather are in the form of informal working relationships. We believe these relationships are valuable to our success. In particular, these relationships provide us with insights into product development and emerging technologies, which allows us to keep abreast of, or anticipate, market trends and helps us serve our current and prospective customers. Because these relationships are not typically governed by written agreements, there is no obligation for many of our partners to continue working with us. If we are unable to maintain our existing strategic relationships with mobile device manufacturers or if we fail to enter into additional strategic relationships or the parties with whom we have strategic relationships favor one of our competitors, our ability to provide products that meet our current and prospective customers' needs could be compromised and our reputation and future revenue prospects could suffer. For example, if our software does not function well with a popular mobile device because we have not maintained a relationship with its manufacturer, carriers seeking to provide that device to their respective customers could choose a competitor's software over ours or develop their own. Even if we succeed in establishing these relationships, they may not result in additional customers or revenues.



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***Our growth depends in part on our customers' ability and willingness to promote services and attract and retain new customers or achieve other goals outside of our control.***

We sell our products for use on handheld devices primarily through our carrier customers. Losing the support of these customers may limit our ability to compete in existing and potential markets and could negatively affect our revenues. In addition, the success of these customers and their ability and willingness to market services supported by our products are critical to our future success. Our ability to generate revenues from sales of our software is also constrained by our carrier customers' ability to attract and retain customers. We have no input into or influence upon their marketing efforts and sales and customer retention activities. If our large carrier customers fail to maintain or grow demand for their services, revenues or revenue growth from our products designed for use on mobile devices will decline and our results of operations will suffer.

***Our operating results may be adversely impacted by the continued worldwide economic slowdown and uncertainties in the marketplace.***

Since the second half of 2008, economic conditions worldwide and in the United States have experienced a general deterioration, resulting in slower economic activity and a highly uncertain recovery, decreased consumer confidence and retail spending, reduced corporate profits and capital spending, and generally adverse business conditions. These conditions make it difficult for our wireless carrier and OEM customers and their end users to accurately forecast and plan future business activities and capital expenditures, which could cause them to slow spending on our products and services. Furthermore, during challenging economic times our customers may face issues gaining timely access to sufficient credit, which could result in an impairment of their ability to make timely payments to us. We cannot predict the timing, strength or duration of the current economic slowdown or the emerging economic recovery, or to what extent they will continue to affect us. If the economy, consumer spending or the markets in which we operate do not continue at their present levels or deteriorate, we may need to record charges related to restructuring costs and the impairment of long-lived assets, and our business, financial condition and results of operations will likely be materially and adversely affected.

***Acquisitions of companies or technologies may disrupt our business and divert management attention and cause our current operations to suffer.***

We have historically made targeted acquisitions of smaller companies with important technology and expect to continue to do so in the future. As part of any acquisition, we will be required to assimilate the operations, products and personnel of the acquired businesses and train, retain and motivate key personnel from the acquired businesses. We may not be able to maintain uniform standards, controls, procedures and policies if we fail in these efforts. Similarly, acquisitions may cause disruptions in our operations and divert management's attention from our company's day-to-day operations, which could impair our relationships with our current employees, customers and strategic partners. Acquisitions may also subject us to liabilities and risks that are not known or identifiable at the time of the acquisition.

We may also have to incur debt or issue equity securities in order to finance future acquisitions. Our financial condition could be harmed to the extent we incur substantial debt or use significant amounts of our cash resources in acquisitions. The issuance of equity securities for any acquisition could be substantially dilutive to our existing stockholders. In addition, we expect our profitability could be adversely affected because of acquisition-related accounting costs, write offs, amortization expenses, and charges related to acquired intangible assets. In consummating acquisitions, we are also subject to risks of entering geographic and business markets in which we have had limited or no prior experience. If we are unable to fully integrate acquired businesses, products or technologies within existing operations, we may not receive the intended benefits of acquisitions.

***Our operating income or loss may continue to change due to shifts in our sales mix and increased spending on our research and development and infrastructure.***

Our operating income or loss can change quarter to quarter and year to year due to a change in our sales mix and the timing of our continued investments in research and development and infrastructure. We continue to invest in research and development which is the lifeline of our technology portfolio. In addition we continue to invest in our infrastructure with facility expansions in Aliso Viejo, California and a new engineering design and data center in Pittsburgh, Pennsylvania. The timing of these additional expenses can vary significantly quarter to quarter and even from year to year.

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### ***Our products may contain undetected software defects, which could negatively affect our revenues.***

Our software products are complex and may contain undetected defects. In the past, we have discovered software defects in certain of our products and have experienced delayed or lost revenues during the period it took to correct these problems. Although we and our OEM customers test our products, it is possible that errors may be found or occur in our new or existing products after we have commenced commercial shipment of those products. Defects, whether actual or perceived, could result in adverse publicity, loss of revenues, product returns, a delay in market acceptance of our products, loss of competitive position or claims against us by customers. Any such problems could be costly to remedy and could cause interruptions, delays, or cessation of our product sales, which could cause us to lose existing or prospective customers and could negatively affect our results of operations. In addition, some of our software contains open source components that are licensed under the GNU General Public License and similar open source licenses. These components may contain undetected defects or incompatibilities, may cause us to lose control over the development of portions of our software code, and may expose us to claims of infringement if these components are, or incorporate, infringing materials, the licenses are not enforceable or are modified to become incompatible with other open source licenses, or exposure to misappropriation claims if these components include unauthorized materials from a third party.

### ***Regulations affecting our customers and us and future regulations, to which they or we may become subject to, may harm our business.***

Certain of our customers in the communications industry are subject to regulation by the Federal Communications Commission, which could have an indirect effect on our business. In addition, the United States telecommunications industry has been subject to continuing deregulation since 1984. We cannot predict when, or upon what terms and conditions, further regulation or deregulation might occur or the effect regulation or deregulation may have on demand for our products from customers in the communications industry. Demand for our products may be indirectly affected by regulations imposed upon potential users of those products, which may increase our costs and expenses.

### ***We may be unable to adequately protect our intellectual property and other proprietary rights, which could negatively impact our revenues.***

Our success is dependent upon our software code base, our programming methodologies and other intellectual properties and proprietary rights. In order to protect our proprietary technology, we rely on a combination of trade secrets, nondisclosure agreements, patents, and copyright and trademark law. We currently own U.S. trademark registrations for certain of our trademarks and U.S. patents for certain of our technologies. However, these measures afford us only limited protection. Furthermore, we rely primarily on shrink wrap licenses that are not signed by the end user and, therefore, may be unenforceable under the laws of certain jurisdictions. Accordingly, it is possible that third parties may copy or otherwise obtain our rights without our authorization. It is also possible that third parties may independently develop technologies similar to ours. It may be difficult for us to detect unauthorized use of our intellectual property and proprietary rights.

We may be subject to claims of intellectual property infringement as the number of trademarks, patents, copyrights and other intellectual property rights asserted by companies in our industry grows and the coverage of these patents and other rights and the functionality of software products increasingly overlap. From time to time, we have received communications from third parties asserting that our trade name or features, content, or trademarks of certain of our products infringe upon intellectual property rights held by such third parties. We have also received correspondence from third parties separately asserting that our products may infringe on certain patents held by each of the parties. Although we are not aware that any of our products infringe on the proprietary rights of others, third parties may claim infringement by us with respect to our current or future products. Additionally, our customer agreements require that we indemnify our customers for infringement claims made by third parties involving our intellectual property embedded in their products. Infringement claims, whether with or without merit, could result in time-consuming and costly litigation, divert the attention of our management, cause product shipment delays or require us to enter into royalty or licensing agreements with third parties. If we are required to enter into royalty or licensing agreements, they may not be on terms that are acceptable to us. Unfavorable royalty or licensing agreements could seriously impair our ability to market our products.

### ***We may raise additional capital through the issuance of additional equity or convertible debt securities or by borrowing money, in order to meet our capital needs. Additional funds may not be available on terms acceptable to us to allow us to meet our capital needs.***

We believe that the cash and cash equivalents and short-term investments on hand and the cash we expect to generate from operations will be sufficient to meet our capital needs for at least the next twelve months. However, it is possible that we may need or choose to obtain additional financing to fund our activities in the future. We could raise these funds by selling more stock to the public or to selected investors, or by borrowing money. We may not be able to obtain additional funds on favorable terms, or at all. If adequate funds are not available, we may be required to curtail our operations or other business activities significantly or to obtain funds through arrangements with strategic partners or others that may require us to relinquish rights to certain technologies or potential markets.



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We have on file with the SEC a shelf Form S-3 to sell from time to time up to 4,000,000 shares of our common stock in one or more offerings in amounts, at prices and on the terms that we will determine at the time of offering. In addition, we have on file with the SEC a shelf Form S-4 to sell from time to time up to 1,000,000 shares of our common stock in connection with our future acquisitions of other businesses, assets or securities. If we raise additional funds by issuing additional equity or convertible debt securities (whether in a public offering or private placement), the ownership percentages of existing stockholders would be reduced. In addition, the equity or debt securities that we issue may have rights, preferences or privileges senior to those of the holders of our common stock. We currently have no established line of credit or other business borrowing facility in place.

It is possible that our future capital requirements may vary materially from those now planned. The amount of capital that we will need in the future will depend on many factors, including:

the market acceptance of our products;

the levels of promotion and advertising that will be required to launch our products and achieve and maintain a competitive position in the marketplace;

our business, product, capital expenditure and research and development plans and product and technology roadmaps;

the levels of inventory and accounts receivable that we maintain;

capital improvements to new and existing facilities;

technological advances;

our competitors' response to our products; and

our relationships with suppliers and customers.

In addition, we may raise additional capital to accommodate planned growth, hiring, infrastructure and facility needs or to consummate acquisitions of other businesses, products or technologies.

### ***We risk being delisted from NASDAQ if our stock trades below \$1.00 per share.***

Our stock is currently trading above \$1.00 per share. However, if our stock price were to drop below \$1.00 per share and remain below \$1.00 per share for an extended period of time, we would be in violation of the continued listing requirements of the NASDAQ Global Market ( NASDAQ ) and would risk delisting of our shares from NASDAQ. If our common stock were delisted from NASDAQ, this could have a number of negative consequences, including reduced liquidity of our common stock, the loss of federal preemption of state securities laws, potential loss of confidence by suppliers, customers and employees, loss of additional analyst coverage and institutional investor interest, and more difficulty in raising capital on favorable terms, if at all.

Two analysts have dropped coverage subsequent to our reporting date, but prior to our filing date. In addition, our market capitalization is currently below \$50 million. If our market capitalization remains below \$50 million for an extended period of time, additional investment analysts who follow our stock may drop their coverage of the Company, which could reduce interest in our stock by institutional investors and reduce liquidity of our shares.

*Our business, financial condition and operating results could be adversely affected as a result of legal, business and economic risks specific to international operations.*

In recent years, our revenues derived from sales to customers outside the U.S. have not been material. Our revenues derived from such sales can vary from quarter to quarter and from year to year. We also frequently ship products to our domestic customers' international manufacturing divisions and subcontractors. In the future, we may expand these international business activities. International operations are subject to many inherent risks, including:

general political, social and economic instability;

trade restrictions;

the imposition of governmental controls;

exposure to different legal standards, particularly with respect to intellectual property;

burdens of complying with a variety of foreign laws;

import and export license requirements and restrictions of the United States and any other country in which we operate;

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unexpected changes in regulatory requirements;

foreign technical standards;

changes in tariffs;

difficulties in staffing and managing international operations;

difficulties in securing and servicing international customers;

difficulties in collecting receivables from foreign entities;

fluctuations in currency exchange rates and any imposition of currency exchange controls; and

potentially adverse tax consequences.

These conditions may increase our cost of doing business. Moreover, as our customers are adversely affected by these conditions, our business with them may be disrupted and our results of operations could be adversely affected.

***We have been named as a party to a purported class action and shareholder derivative lawsuit and we may be named in additional litigation, all of which could require significant management time and attention and result in significant legal expenses. An unfavorable outcome in one or more of these lawsuits could have a material adverse effect on our business, financial condition, results of operations and cash flows.***

As described in detail in Item 1. Legal Proceedings of Part II of this Quarterly Report on Form 10-Q, on June 29, 2011, a complaint was filed in the U.S. District Court for the Central District of California against us and certain of our current and past officers and directors on behalf of certain purchasers of our common stock. The complaint has been brought as a purported stockholder class action, and, in general, includes allegations that we and certain of our officers and directors violated federal securities laws by making materially false and misleading statements regarding our business prospects and financial results, thereby artificially inflating the price of our common stock. The plaintiff is seeking unspecified monetary damages and other relief. On August 29, 2011, two prospective lead plaintiffs filed motions for appointment of lead plaintiff and for appointment of lead counsel. On October 17, 2011, the court appointed the two prospective lead plaintiffs as co-lead plaintiffs and their respective counsel as co-lead counsel. We expect the co-lead plaintiffs to file an amended complaint. We intend to vigorously defend against the claims advanced, and intend to file a motion to dismiss the amended complaint.

On August 11, 2011, a shareholder derivative complaint was filed in the Superior Court of California for the County of Orange against the Company's directors and certain of its executive officers. Thereafter, two additional similar complaints, also styled as shareholder derivative actions, were filed in state court (collectively, the State Derivative Actions). On September 12, 2011, a shareholder derivative complaint was filed in the U.S. District Court for the Central District of California against certain of the officers and directors named in the State Derivative Actions but also against additional officers of the company (the Federal Derivative Action). Collectively, the State Derivative Actions and the Federal Derivative Action are referred to as the Derivative Actions. The complaints in the Derivative Actions allege breaches of fiduciary duties by the defendants and other violations of state law. In general, the complaints in the Derivative Actions allege that the Company's directors and certain of its officers caused or allowed for the dissemination of materially false and misleading statements regarding our business prospects and financial results, thereby artificially inflating the price of our common stock. Plaintiffs in the Derivative Actions seek unspecified monetary damages and other relief, including reforms and improvements to the Company's corporate governance and internal procedures. We intend to vigorously defend against the claims advanced in the Derivative Actions, and intend to file demurrers and/or motion(s) to dismiss the complaints in the Derivative Actions.

Regardless of the merits, the expense of defending such litigation may have a substantial impact if our insurance carriers fail to cover the cost of the litigation, and the time required to defend the actions could divert management's attention from the day-to-day operations of our business,

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which could adversely affect our business, results of operations and cash flows. In addition, an unfavorable outcome in such litigation could have a material adverse effect on our business, results of operations and cash flows.

### Item 6. Exhibits.

|           |                                                                                                     |
|-----------|-----------------------------------------------------------------------------------------------------|
| 31.1      | Certification of Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. |
| 31.2      | Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. |
| 32.1      | Certification Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.                            |
| 101.INS** | XBRL Instance Document                                                                              |
| 101.SCH** | XBRL Taxonomy Extension Schema Document                                                             |
| 101.CAL** | XBRL Taxonomy Extension Calculation Linkbase Document                                               |
| 101.LAB** | XBRL Taxonomy Extension Label Linkbase Document                                                     |
| 101.PRE** | XBRL Taxonomy Extension Presentation Linkbase Document                                              |

\*\* XBRL (Extensible Business Reporting Language) information is furnished and not filed or a part of a registration statement or prospectus for purposes of Sections 11 or 12 of the Securities Act of 1933, is deemed not filed for purposes of Section 18 of the Securities Exchange Act of 1934, and otherwise is not subject to liability under these sections.

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**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.

SMITH MICRO SOFTWARE, INC.

November 3, 2011

By /s/ William W. Smith, Jr.  
William W. Smith, Jr.  
President and Chief Executive Officer  
(Principal Executive Officer)

November 3, 2011

By /s/ Andrew C. Schmidt  
Andrew C. Schmidt  
Vice President and Chief Financial Officer  
(Principal Financial Officer)

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