INTELLIGENT SYSTEMS CORP
Form 10-Q
November 12, 2010

Table of Contents

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

(Mark One)

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

For the quarterly period ended September 30, 2010

OR

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

For the transition period from __________ to __________

Commission file number 1-9330

INTELLIGENT SYSTEMS CORPORATION

(Exact name of registrant as specified in its charter)

Georgia	**58-1964787**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
4355 Shackleford Road, Norcross, Georgia	**30093**
(Address of principal executive offices)	(Zip Code)

Registrant s telephone number, including area code: **(770) 381-2900**

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes þ No o

Indicate by check mark whether the registrant 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 o No o

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 o	Accelerated filer o	Non-accelerated filer o (Do not check if a smaller reporting company)	Smaller reporting company þ

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

Indicate the number of shares outstanding of each of the issuer s classes of common stock, as of the latest practicable date.

As of October 31, 2010, 8,958,028 shares of Common Stock of the issuer were outstanding.

Intelligent Systems Corporation
Index
Form 10-Q

Table of Contents

Part I FINANCIAL INFORMATION
Item 1. Financial Statements

Intelligent Systems Corporation
CONSOLIDATED BALANCE SHEETS
(in thousands, except share amounts)

	September 30, 2010 (unaudited)	December 31, 2009
ASSETS		
Current assets:		
Cash	$ 2,332	$ 2,795
Accounts receivable, net	2,652	1,680
Notes and interest receivable, current portion	992	492
Inventories, net	864	964
Other current assets	458	399
Total current assets	7,298	6,330
Long-term investments	1,186	1,219
Notes and interest receivable, net of current portion	560	1,006
Property and equipment, at cost less accumulated depreciation	1,216	1,256
Patents, net	189	223
Total assets	$ 10,449	$ 10,034
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 429	$ 576
Deferred revenue	1,138	1,355
Accrued payroll	523	423
Accrued expenses	782	565
Other current liabilities	347	406
Total current liabilities	3,219	3,325
Long-term liabilities	111	100
Commitments and contingencies (Note 8)		
Intelligent Systems Corporation stockholders equity:		
Common stock, $0.01 par value, 20,000,000 shares authorized, 8,958,028 shares issued and outstanding at September 30, 2010 and December 31, 2009	90	90
Additional paid-in capital	21,416	21,410
Accumulated other comprehensive income (loss)	2	(28)
Accumulated deficit	(15,905)	(16,379)
Total Intelligent Systems Corporation stockholders equity	5,603	5,093
Non-controlling interest	1,516	1,516

Total stockholders equity		7,119		6,609
Total liabilities and stockholders equity	$	10,449	$	10,034

The accompanying notes are an integral part of these Consolidated Financial Statements.

Intelligent Systems Corporation
CONSOLIDATED STATEMENTS OF OPERATIONS
(unaudited; in thousands, except share and per share amounts)

	Three Months Ended Sept. 30,		Nine Months Ended Sept. 30,	
	2010	**2009**	**2010**	**2009**
Revenue				
Products	$ 3,214	$ 3,147	$ 10,325	$ 8,215
Services	602	268	1,796	1,112
Total revenue	3,816	3,415	12,121	9,327
Cost of revenue				
Products	1,626	1,616	5,494	4,285
Services	266	202	827	743
Total cost of revenue	1,892	1,818	6,321	5,028
Expenses				
Marketing	527	556	1,646	1,456
General & administrative	654	972	2,052	2,662
Research & development	638	620	1,566	1,630
Income (loss) from operations	105	(551)	536	(1,449)
Other income (expense)				
Interest income, net	19	26	63	57
Equity in income (loss) of affiliate company	(10)	4	(32)	24
Other income	4	6	17	18
Income (loss) before income taxes	118	(515)	584	(1,350)
Income taxes	27	6	110	10
Net income (loss)	$ 91	$ (521)	$ 474	$ (1,360)
Income (loss) per share:				
Basic	$ 0.01	$ (0.07)	$ 0.05	$ (0.25)
Diluted	$ 0.01	$ (0.07)	$ 0.05	$ (0.25)
Basic weighted average common shares outstanding	8,958,028	7,465,023	8,958,028	5,474,350
Diluted weighted average common shares outstanding	8,962,426	7,465,023	8,962,720	5,474,350

The accompanying notes are an integral part of these Consolidated Financial Statements.

Table of Contents

Intelligent Systems Corporation
CONSOLIDATED STATEMENTS OF CASH FLOWS
(unaudited, in thousands)

	Nine Months Ended September 30,	
CASH PROVIDED BY (USED FOR):	**2010**	**2009**
OPERATIONS:		
Net income (loss)	$ 474	$ (1,360)
Adjustments to reconcile net income (loss) to net cash used for operating activities:		
Depreciation and amortization	371	414
Stock-based compensation expense	7	9
Non-cash interest income, net	(54)	(54)
Equity in (income) loss of affiliate company	32	(24)
Changes in operating assets and liabilities		
Accounts receivable	(972)	(435)
Inventories	101	247
Accrued interest	(6)	2
Other current assets	(60)	(142)
Accounts payable	(147)	209
Deferred revenue	(217)	513
Accrued payroll	99	(9)
Accrued expenses and other current liabilities	220	(9)
Other liabilities	65	(6)
Net cash used for operating activities	(87)	(645)
INVESTING ACTIVITIES:		
Proceeds from notes and interest receivable	7	352
Purchases of property and equipment	(297)	(112)
Net cash provided by (used for) investing activities	(290)	240
FINANCING ACTIVITIES:		
Borrowings under line of credit		335
Repayments made under line of credit		(660)
Payments on notes payable	(116)	(74)
Proceeds from rights offering		2,986
Net cash provided by (used for) financing activities	(116)	2,587
Effects of exchange rate changes on cash	30	15
Net increase (decrease) in cash	(463)	2,197

Cash at beginning of period		2,795		1,074
Cash at end of period	$	2,332	$	3,271
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:				
Cash paid during the period for interest	$	3	$	26
Cash paid during the period for income taxes	$	52	$	2

The accompanying notes are an integral part of these Consolidated Financial Statements.

Table of Contents

Intelligent Systems Corporation
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(unaudited)

1. Throughout this report, the terms we , us , ours , ISC and company refer to Intelligent Systems Corporation, including its wholly-owned and majority-owned subsidiaries.
2. The unaudited Consolidated Financial Statements presented in this Form 10-Q have been prepared in accordance with accounting principles generally accepted in the United States applicable to interim financial statements. Accordingly, they do not include all of the information and notes required for complete financial statements. In the opinion of ISC management, these Consolidated Financial Statements contain all adjustments (which comprise only normal and recurring accruals) necessary to present fairly the financial position and results of operations as of and for the three and nine month periods ended September 30, 2010 and 2009. The interim results for the three and nine months ended September 30, 2010 are not necessarily indicative of the results to be expected for the full year. These statements should be read in conjunction with our Consolidated Financial Statements and notes thereto for the fiscal year ended December 31, 2009, as filed in our Annual Report on Form 10-K.
3. *Comprehensive Income (Loss)* Comprehensive income (loss) is the total of net income (loss) and all other non-owner changes in equity in a period. A summary follows:

Consolidated Statements of Comprehensive Income (Loss)	**Three Months Ended Sept. 30,**		**Nine Months Ended Sept. 30,**	
(unaudited, in thousands)	**2010**	**2009**	**2010**	**2009**
Net income (loss)	$ 91	$ (521)	$ 474	$ (1,360)
Other comprehensive income:				
Foreign currency translation adjustment	10	9	30	15
Comprehensive income (loss)	$ 101	$ (512)	$ 504	$ (1,345)

4. *Stock-based Compensation* At September 30, 2010, we have two stock based compensation plans in effect. We record compensation cost related to unvested stock-based awards by recognizing the unamortized grant date fair value on a straight line basis over the service periods of each award. We have estimated forfeiture rates based on our historical experience. Stock-based compensation expense is recognized as a component of general and administrative expenses in the accompanying Consolidated Financial Statements. We recorded $1,500 and $3,000 of stock-based compensation expense in the three months ended September 30, 2010 and 2009, respectively and $6,000 and $9,000 for the nine month periods ended September 30, 2010 and 2009, respectively. The estimated fair value of options granted is calculated using the Black-Scholes option pricing model with assumptions as previously disclosed in our Form 10-K.

As of September 30, 2010, there is $10,500 of unrecognized compensation cost related to stock options. No options were granted, exercised or cancelled during the three month period ended September 30, 2010. During the nine month period ended September 30, 2010, 11,000 employee options and 20,000 director options expired unexercised and an aggregate of 12,000 options were granted to the three independent members of our board of directors pursuant to the non-employee director stock option plan (Director Plan). Pursuant to the terms of the Director Plan, the options were granted at fair market value on the date of the Annual Shareholders meeting. The following table summarizes options as of September 30, 2010:

	# of	**Wgt Avg**	**Wgt Avg Remaining Contractual Life**	**Aggregate Intrinsic**

	Shares	Exercise Price	in Years	Value
Outstanding at September 30, 2010	214,000	$ 2.06	3.8	$ 3,720
Vested at September 30, 2010	196,000	$ 2.15	3.3	$ 1,860

The aggregate intrinsic value in the table above represents the total pre-tax intrinsic value (the difference between the company s closing stock price on the last trading day of the third quarter of 2010 and the exercise price, multiplied by the number of in-the-money options) that would have been received by the option holders had all option holders exercised their options on September 30, 2010. The amount of aggregate intrinsic value will change based on the fair market value of the company s stock.

Table of Contents

5. *Fair Value of Financial Instruments* - The carrying value of cash, accounts receivable, accounts payable and certain other financial instruments (such as short-term borrowings, accrued expenses, and other current liabilities) included in the accompanying consolidated balance sheets approximates their fair value principally due to the short-term maturity of these instruments. The carrying value of non-interest bearing notes receivable beyond one year have been discounted at a rate of 6% which approximates rates offered in the market for notes receivable with similar terms and conditions. The fair value of equity method and cost method investments has not been determined as it was impracticable to do so.

Financial instruments that potentially subject us to concentrations of credit risk consist principally of cash, trade accounts and notes receivable. Our available cash is held in accounts managed by third-party financial institutions. Cash may exceed the Federal Deposit Insurance Corporation, or FDIC, insurance limits. While we monitor cash balances on a regular basis and adjust the balances as appropriate, these balances could be impacted if the underlying financial institutions fail. To date, we have experienced no loss or lack of access to our cash; however, we can provide no assurances that access to our cash will not be impacted by adverse conditions in the financial markets.

6. *Concentration of Revenue* The following table indicates the percentage of consolidated revenue represented by each customer for any period in which such customer represented more than 10% of consolidated revenue.

	Three Months Ended Sept. 30,		**Nine Months Ended Sept. 30,**	
(unaudited)	**2010**	**2009**	**2010**	**2009**
ChemFree Customer A	34%	41%	32%	37%
ChemFree Customer B		12%	12%	13%
ChemFree Customer C	10%	11%		12%

7. *Short-term Borrowings* On June 28, 2010, we renewed our working capital line of credit with our bank. The revolving line of credit bears interest at the higher of the prime rate plus one and one half percent and 6.5% (6.5% at September 30, 2010), is collateralized by all assets of the company and expires June 30, 2011. We may borrow an aggregate of 80 percent of qualified accounts receivable plus 50 percent of inventory, up to a maximum of $1,250,000. At September 30, 2010, our borrowing base calculation resulted in availability of $1,250,000, of which we had drawn down $0. The terms of the line of credit contain typical covenants not to sell or transfer material assets, to create liens against assets, to merge with another entity, to change corporate structure or the nature of our business, to declare or pay dividends, or to redeem shares of common stock. The loan agreement also contains covenants not to change the chief executive and chief financial officers of the company or to make loans to or to make new investments in companies, without first obtaining the consent of our bank in each case. Furthermore, the terms of the loan include a covenant requiring the company to maintain a minimum tangible net worth as defined in the loan agreement at the end of each calendar quarter during the loan term. We are in compliance with all loan covenants as of September 30, 2010.

8. *Commitments and Contingencies* Please refer to Note 7 in the Consolidated Financial Statements included in our 2009 Form 10-K for a description of our commitments and contingencies in addition to those disclosed here.

Legal Matters In December 2004, our ChemFree subsidiary filed a patent infringement action against J. Walter Co. Ltd. and J. Walter, Inc. (J. Walter) in the United States Court for the Northern District of Georgia. The complaint alleged that certain of the defendants products infringed four U.S. patents held by ChemFree and sought a ruling to compel the defendants to cease their infringing activities. The trial took place during the week of July 13, 2009. On June 18, 2010, the judge issued his Findings of Fact and Conclusions of Law which found (i) that certain of J. Walter s products did infringe on ChemFree s four patents-in-suit; (ii) in ChemFree s favor on the issue of the patents named co-inventors and (iii) in J. Walter s favor on the issue of invalidity of the four patents-in-suit for obviousness . In his ruling on invalidity of four of ChemFree s patents due to obviousness, the judge relied heavily on a 2007 U.S. Supreme Court ruling (issued more than three years after ChemFree s lawsuit was filed) which modified the manner for determining obviousness of a patent by replacing the long-standing rigid application of the teaching, suggestion or motivation test for determining obviousness with an expansive and flexible approach . On July 6, 2010, ChemFree filed a Motion for Reconsideration of the judge s findings and conclusions followed on July 23, 2010 by the filing of a Second Motion for Additional Findings and Conclusions. In an unusual turn of events, in October 2010, the judge hearing the case was arrested by the Federal Bureau of Investigation on criminal charges. It is our understanding that ChemFree s case will be reassigned to another judge; however we have no indication when that might occur or what impact it will have on the timing and final outcome of this matter.

Table of Contents

IBS Technics, the company that acquired certain assets and the operations of our VISaer subsidiary in April 2008, has alleged a breach of certain representations and warranties in the Asset Purchase Agreement (APA). On April 15, 2010, we received a claim from IBS Technics seeking indemnification under the APA in the amount of approximately $2.6 million. We denied that claim on May 13, 2010. On June 21, 2010, we formally notified IBS Technics and IBS Software Services Americas, Inc, as guarantor, that they had failed to make a guaranteed deferred payment of $500,000 due to us on June 14, 2010 in accordance with the terms of the APA. On September 8, 2010, we filed a demand for arbitration against IBS Technics and IBS Americas Software Services, Inc. with the American Arbitration Association as required under the APA seeking the $500,000, in addition to interest, costs and attorneys fees. On October 11, 2010, IBS Technics and IBS Software Services Americas, Inc. filed a response denying our claim and a counterclaim seeking nearly $2.5 million, in addition to interest, costs and attorneys fees. We filed a response to the counterclaim on November 4, 2010. Given the status of the matter and our belief that we have reasonable grounds to refute IBS Technics and IBS Software Services Americas, Inc. s allegations and to prevail in the matter, presently we have not taken a reserve against the amount receivable from IBS Technics. However, if we do not prevail in the arbitration matter, it is at least reasonably possible that the amount of the receivable could be reduced or eliminated and that we could be required to pay damages.

Except as noted above, other commitments and contingencies described in Note 7 to our Consolidated Financial Statements included in our 2009 Form 10-K are unchanged.

9. *Industry Segments* Segment information is presented consistently with the basis described in our 2009 Form 10-K. The following table contains segment information for continuing operations for the three and nine months ended September 30, 2010 and 2009.

	Three Months Ended Sept. 30,		Nine Months Ended Sept. 30,	
(unaudited, in thousands)	**2010**	**2009**	**2010**	**2009**
Information Technology				
Revenue	$ 696	$ 412	$ 2,634	$ 1,322
Operating loss	(357)	(603)	(675)	(1,449)
Industrial Products				
Revenue	3,120	3,003	9,487	8,005
Operating income	662	298	1,974	884
Consolidated Segments				
Revenue	3,816	3,415	12,121	9,327
Operating income	305	(305)	1,299	(565)
Corporate expenses	(200)	(246)	(763)	(884)
Consolidated operating income (loss)	$ 105	$ (551)	$ 536	$ (1,449)
Depreciation and Amortization				
Information Technology	$ 39	$ 28	$ 64	$ 57
Industrial Products	93	111	295	343
Consolidated segments	132	139	359	400
Corporate	4	4	12	14
Consolidated depreciation and amortization	$ 136	$ 143	$ 371	$ 414

Capital Expenditures								
Information Technology	$	36	$	18	$	194	$	65
Industrial Products		20		28		87		41
Consolidated segments		56		46		281		106
Corporate		15		1		16		6
Consolidated capital expenditures	$	71	$	47	$	297	$	112

(unaudited, in thousands)		**Sept. 30, 2010**		**Dec. 31, 2009**
Identifiable Assets				
Information Technology	$	2,001	$	2,693
Industrial Products		5,806		3,824
Consolidated segments		7,807		6,517
Corporate		2,642		3,517
Consolidated assets	$	10,449	$	10,034

Table of Contents

10. *Income Taxes* As of September 30, 2010, the company has recorded a liability of $65,000 in connection with unrecognized tax benefits related to uncertain tax positions. The liability includes $8,622 of interest and penalties. As of September 30, 2010, management expects some incremental but not significant changes in the balance of unrecognized tax benefits over the next twelve months.

Our policy is to recognize accrued interest related to uncertain tax positions in interest expense and related penalties, if applicable, in general and administrative expense. During the three and nine months ended September 30, 2010