

INTELLIGENT SYSTEMS CORP

Form 10QSB

May 13, 2005

**Table of Contents**

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

**FORM 10-QSB**

(Mark One)

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

For the quarterly period ended March 31, 2005

OR

**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)

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

Indicate by a check mark whether the issuer (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the past 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

As of April 30, 2005, 4,478,971 shares of Common Stock were outstanding.

Transitional Small Business Disclosure Format (check one): Yes  No



**TABLE OF CONTENTS**

Item 1. Financial Statements

Item 2. Management's Discussion and Analysis or Plan of Operations

Item 3. Controls and Procedures

Part II. OTHER INFORMATION

Item 6. Exhibits

SIGNATURES

EX-31.1 SECTION 302, CERTIFICATION OF THE CEO

EX-31.2 SECTION 302, CERTIFICATION OF THE CFO

EX-32.1 SECTION 906, CERTIFICATION OF THE CEO AND CFO

---

**Table of Contents****Item 1. Financial Statements**

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

|   | <b>March 31,<br/>2005</b> | <b>December<br/>31,<br/>2004</b> |
|---|---------------------------|----------------------------------|
|   | <i>(unaudited)</i>        |                                  |
| <b>ASSETS</b>   |                           |                                  |
| <b>Current assets:</b>  |                           |                                  |
| Cash  | \$ 1,632                  | \$ 670                           |
| Accounts receivable, net                                      | 2,542                     | 2,931                            |
| Inventories   | 654                       | 653                              |
| Other current assets  | 387                       | 217                              |
| Total current assets  | 5,215                     | 4,471                            |
| Long-term investments   | 4,787                     | 4,879                            |
| Property and equipment, at cost less accumulated depreciation | 721                       | 781                              |
| Goodwill, net   | 2,047                     | 2,049                            |
| Other intangibles, net  | 661                       | 699                              |
| Other assets, net   | 17                        | 25                               |
| Total assets  | \$ 13,448                 | \$ 12,904                        |
| <b>LIABILITIES AND STOCKHOLDERS EQUITY</b>                    |                           |                                  |
| <b>Current liabilities:</b>                                   |                           |                                  |
| Short-term borrowings   | \$ 131                    | \$ 267                           |
| Accounts payable  | 878                       | 867                              |
| Deferred revenue  | 5,746                     | 4,895                            |
| Accrued payroll   | 1,072                     | 928                              |
| Accrued expenses and other current liabilities                | 539                       | 552                              |
| Total current liabilities                                     | 8,366                     | 7,509                            |
| Other long-term liabilities                                   | 310                       | 310                              |
| Commitments and contingencies (Note 8)                        |                           |                                  |
| Minority interest   | 1,516                     | 1,516                            |
| Stockholders' equity:   |                           |                                  |
|   | 45                        | 45                               |

Edgar Filing: INTELLIGENT SYSTEMS CORP - Form 10QSB

Common stock, \$0.01 par value, 20,000,000 shares authorized, 4,478,971 shares issued and outstanding at March 31, 2005 and December 31, 2004

|  |           |           |
|--|-----------|-----------|
| Paid-in capital                            | 18,410    | 18,410    |
| Accumulated other comprehensive loss       | (218)     | (124)     |
| Accumulated deficit                        | (14,981)  | (14,762)  |
| Total stockholders' equity                 | 3,256     | 3,569     |
| Total liabilities and stockholders' equity | \$ 13,448 | \$ 12,904 |

*The accompanying notes are an integral part of these consolidated balance sheets.*

**Table of Contents**

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

|   | <b>Three Months Ended March</b> |             |
|---|---------------------------------|-------------|
|   | <b>31,</b>                      |             |
|   | <b>2005</b>                     | <b>2004</b> |
| Revenue   |                                 |             |
| Products  | \$ 2,063                        | \$ 3,227    |
| Services  | 1,516                           | 1,385       |
| Total revenue   | 3,579                           | 4,612       |
| Cost of sales   |                                 |             |
| Products  | 863                             | 985         |
| Services  | 869                             | 810         |
| Total cost of sales                                   | 1,732                           | 1,795       |
| Expenses  |                                 |             |
| Marketing   | 541                             | 660         |
| General & administrative                              | 959                             | 894         |
| Research & development                                | 1,627                           | 2,100       |
| Loss from operations                                  | (1,280)                         | (837)       |
| Other income  |                                 |             |
| Interest income (expense), net                        | 6                               | (3)         |
| Investment income                                     | 1,042                           |             |
| Equity in income (losses) of affiliate companies      | 17                              | (38)        |
| Other income, net                                     | 8                               | 59          |
| Loss before income tax provision                      | (207)                           | (819)       |
| Income tax provision                                  | 12                              | 1           |
| Net loss  | \$ (219)                        | \$ (820)    |
| Basic and diluted net loss per share                  | \$ (0.05)                       | \$ (0.18)   |
| Basic and diluted weighted average shares outstanding | 4,478,971                       | 4,478,971   |

*The accompanying notes are an integral part of these consolidated financial statements.*





**Table of Contents**

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

|   | <b>Three Months Ended March<br/>31,</b> |             |
|---|---|-------------|
| <b>CASH PROVIDED BY (USED FOR):</b>   | <b>2005</b>                             | <b>2004</b> |
| <b>OPERATIONS:</b>  |   |             |
| Net loss  | \$ (219)                                | \$ (820)    |
| Adjustments to reconcile net loss to net cash provided by (used for) operating activities, net of effects of acquisitions and dispositions: |   |             |
| Depreciation and amortization   | 124                                     | 172         |
| Deferred gain recognized  |   | (33)        |
| Investment income   | (1,042)                                 |             |
| Equity in (earnings) losses of affiliate companies  | (17)                                    | 38          |
| Changes in operating assets and liabilities, net of effects of acquisition  |   |             |
| Accounts receivable   | 389                                     | (579)       |
| Inventories   | (1)                                     | 202         |
| Deferred revenue  | 851                                     | 680         |
| Other current assets  | (170)                                   | 90          |
| Accounts payable  | 11                                      | 289         |
| Accrued payroll   | 144                                     | (267)       |
| Other non-current assets  | 10                                      |             |
| Accrued expenses and other current liabilities  | (13)                                    | (56)        |
| Cash provided by (used for) operating activities  | 67                                      | (284)       |
| <b>INVESTING ACTIVITIES:</b>  |   |             |
| Proceeds related to sale of investments   | 1,042                                   |             |
| Disposition of long-term investments  |   | 28          |
| Repayments under notes receivable   |   | 15          |
| Advances under notes receivable   |   | (13)        |
| Purchases of intangible assets  | (5)                                     |             |
| Purchases of property and equipment   | (21)                                    | (85)        |
| Cash provided by (used for) investing activities  | 1,016                                   | (55)        |
| <b>FINANCING ACTIVITIES:</b>  |   |             |
| Borrowings under short-term borrowing arrangements  | 405                                     |             |
| Repayments under short-term borrowing arrangements  | (541)                                   |             |
| Cash used for financing activities  | (136)                                   |             |

Edgar Filing: INTELLIGENT SYSTEMS CORP - Form 10QSB

|  |          |        |
|--|----------|--------|
| Effects of exchange rate changes on cash | 15       | (24)   |
| Net increase (decrease) in cash          | 962      | (363)  |
| Cash at beginning of period              | 670      | 1,133  |
| Cash at end of period                    | \$ 1,632 | \$ 770 |

**SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:**

|  |      |      |
|--|------|------|
| Cash paid during the period for interest     | \$ 2 | \$ 3 |
| Cash paid during the period for income taxes | 12   | 1    |

*The accompanying notes are an integral part of these consolidated financial statements.*

**Table of Contents**

**Intelligent Systems Corporation**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

- Throughout this report, the terms we, us, ours, ISC and company refer to Intelligent Systems Corporation, including its majority-owned subsidiaries.
- The unaudited consolidated financial statements presented in this Form 10-QSB 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 month periods ended March 31, 2005 and 2004. The interim results for the three months ended March 31, 2005 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, 2004, as filed in our annual report on Form 10-KSB.
- Comprehensive Income (Loss)** In accordance with Financial Accounting Standards Board Statement No. 130, Reporting Comprehensive Income, 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 Loss<br>(unaudited, in thousands) | Three Months Ended March<br>31, |          |
|--|---------------------------------|----------|
|  | 2005                            | 2004     |
| Net loss   | \$ (219)                        | \$ (820) |
| Other comprehensive income (loss):   |                                 |          |
| Foreign currency translation adjustment                                    | 15                              | (24)     |
| Unrealized loss on available-for-sale securities                           | (109)                           |          |
| Comprehensive loss   | \$ (313)                        | \$ (844) |

- Stock-Based Compensation** At March 31, 2005, we had two stock-based compensation plans. We account for the plans under the intrinsic value recognition and measurement principles of Accounting Principles Board ( APB ) No. 25, Accounting for Stock Issued to Employees, and related interpretations. The intrinsic value recognition is measured by the difference between the exercise price and the market value of the underlying securities. Based on the additional disclosure requirements of Statement of Financial Accounting Standards ( SFAS ) No. 148, Accounting for Stock-Based Compensation Transition and Disclosure an Amendment to SFAS No. 123, the following table illustrates the effect of net income and earnings (loss) per share if we had applied the fair value recognition provisions of SFAS No. 123, Accounting for Stock-Based Compensation.

| (in thousands, except per share data)   | Three Months Ended March<br>31, |          |
|---|---------------------------------|----------|
|   | 2005                            | 2004     |
| Net loss, reported  | \$ (219)                        | \$ (820) |
| Add: stock-based employee compensation included in reported net loss, net of related tax effect | (8)                             | (9)      |

Deduct: stock-based compensation expense determined under fair value based method for all awards, net of related tax effect

|   |           |           |
|---|-----------|-----------|
| Pro forma net loss                                    | \$ (227)  | \$ (829)  |
| Pro forma net loss per common share basic and diluted | \$ (0.05) | \$ (0.19) |

**Table of Contents**

5. *Industry Segments* Our consolidated subsidiaries are involved in two industry segments: Information Technology products and services, and Industrial Products. Operations in Information Technology products and services include development and sales of software licenses and related professional services and software maintenance contracts provided through three subsidiaries: QS Technologies, Inc., VISAer, Inc., and CoreCard Software, Inc. Operations in the Industrial Products segment include the manufacture and sale of bio-remediating parts washing systems by our ChemFree Corporation subsidiary. Total revenue by industry segment includes sales to unaffiliated customers. Sales between our industry segments are not material. Operating profit (loss) is total revenue less operating expenses. None of the corporate overhead expense is allocated to the individual industry segments. Identifiable assets by industry segment are those assets that are used in our subsidiaries in each industry segment. Corporate assets are principally cash, notes receivable and investments. The table following contains segment information for the quarters ended March 31, 2005 and 2004.

| Quarter ended March 31,<br>(unaudited, in thousands)                              | 2005       | 2004     |
|---|------------|----------|
| <i>Information Technology</i>   |            |          |
| Revenue   | \$ 1,876   | \$ 2,954 |
| Operating loss  | (1,308)    | (678)    |
| <i>Industrial Products</i>  |            |          |
| Revenue   | 1,703      | 1,658    |
| Operating income  | 288        | 84       |
| <i>Consolidated Segments</i>  |            |          |
| Revenue   | \$ 3,579   | \$ 4,612 |
| Operating loss  | (1,020)    | (594)    |
| A reconciliation of consolidated segment data above to consolidated loss follows: |            |          |
| Consolidated segments operating loss  | \$ (1,020) | \$ (594) |
| Corporate expenses  | (260)      | (243)    |
| Consolidated operating loss   | (1,280)    | (837)    |
| Interest income (expense)   | 6          | (3)      |
| Investment income   | 1,042      |          |
| Equity of affiliates  | 17         | (38)     |
| Other income  | 8          | 59       |
| Loss before taxes   | (207)      | (819)    |
| Income tax provision  | 12         | 1        |
| Net loss  | \$ (219)   | \$ (820) |
| <i>Depreciation and Amortization</i>  |            |          |
| Information Technology  | \$ 64      | \$ 123   |
| Industrial Products   | 54         | 42       |
| Consolidated segments   | 118        | 165      |
| Corporate   | 6          | 7        |

|  |        |        |
|--|--------|--------|
| Consolidated depreciation and amortization | \$ 124 | \$ 172 |
| <i>Capital Expenditures</i>                |        |        |
| Information Technology                     | \$ 14  | \$ 16  |
| Industrial Products                        | 12     | 69     |
| Consolidated segments                      | 26     | 85     |
| Corporate                                  |        |        |
| Consolidated capital expenditures          | \$ 26  | \$ 85  |

|                            | March 31,<br>2005<br><i>(unaudited)</i> | December 31,<br>2004<br><i>(audited)</i> |
|----------------------------|---|--|
| <i>Identifiable Assets</i> |   |  |
| Information Technology     | \$ 4,651                                | \$ 4,777                                 |
| Industrial Products        | 3,329                                   | 3,013                                    |
| Consolidated segments      | 7,980                                   | 7,790                                    |
| Corporate                  | 5,468                                   | 5,114                                    |
| Consolidated assets        | \$ 13,448                               | \$ 12,904                                |

**Table of Contents**

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.

| <i>(unaudited, in thousands)</i> | Three Months Ended |                   |
|----------------------------------|--------------------|-------------------|
|                                  | 2005               | March 31,<br>2004 |
| VISAer Customer A                | 13%                |                   |
| CoreCard Customer B              |                    | 29%               |
| ChemFree Customer C              | 10%                |                   |
| ChemFree Customer D              | 13%                |                   |

7. *Distribution from ISC Guernsey, Ltd.* During the first quarter of 2005, we received an additional cash distribution from ISC Guernsey, Ltd in the amount of \$1,042,000, which is reflected in investment income for the three months ended March 31, 2005. For further information on the ISC Guernsey transaction, please refer to Note 2 to our Consolidated Financial Statements included in our 2004 Form 10-KSB.

8. *Commitments and Contingencies* Please refer to Note 8 to our Consolidated Financial Statements included in our 2004 Form 10-KSB for a description of our commitments and contingencies.

**Item 2. Management's Discussion and Analysis or Plan of Operations**

*In addition to historical information, this Form 10-QSB may contain forward-looking statements relating to ISC. All statements, trend analysis and other information relative to markets for our products and trends in revenue, gross margins and anticipated expense levels, as well as other statements including words such as anticipate, believe, plan, estimate, expect, and intend, and other similar expressions, constitute forward-looking statements. Prospective investors are cautioned that any such forward-looking statements are not guarantees of future performance and involve risks and uncertainties, and that actual results may differ materially from those contemplated by such forward-looking statements included those factors described below under Factors That May Affect Future Performance. ISC undertakes no obligation to update or revise forward-looking statements to reflect changed assumptions, the occurrence of unanticipated events or changes in future operating results.*

*For purposes of this discussion and analysis, we are assuming and relying upon the reader's familiarity with the information contained in Item 6. Management's Discussion and Analysis or Plan of Operation, in the Form 10-KSB for the year ended December 31, 2004 as filed with the Securities and Exchange Commission.*

**Overview**

Our consolidated subsidiaries operate in two industry segments: Information Technology Products and Services and Industrial Products. Included in the Information Technology sector are QS Technologies, Inc. (software for public health and human services), VISAer, Inc. (software for maintenance, repair and overhaul operations in the commercial aviation industry) and CoreCard Software, Inc. (software for managing credit and debit cards). The Industrial Products segment includes ChemFree Corporation (bio-remediating parts washers).

We derive our product revenue from sales of software licenses in our Information Technology sector and sales and leases of equipment and supplies in our Industrial Products sector. Our service revenue consists of fees for implementation, consulting, training, maintenance and support for software products in our Information Technology sector. Our consolidated revenue is the aggregate of the revenue generated at our four subsidiary companies. Our revenue fluctuates from period to period and our results are not necessarily indicative of the results to be expected in

future periods. Period-to-period comparisons may not be meaningful and it is difficult to predict the level of consolidated revenue on a quarterly or annual basis for a number of reasons, including the following:

A change in revenue level at one of our subsidiaries may impact consolidated revenue or be offset by an opposing change at another subsidiary.

Economic and marketplace trends may impact our subsidiaries differently or not at all and two of our software subsidiaries have very limited experience in their marketplaces which makes it difficult to identify and evaluate trends that may impact their business.



## **Table of Contents**

Two of our software subsidiaries, CoreCard Software and VISAer, have been involved in major new product development initiatives for the past four years and have limited experience delivering and installing their new products at customer sites, making it difficult to predict with certainty when they will recognize revenue on individual software contracts.

Our subsidiaries are relatively small in revenue size and, in the Information Technology sector, license revenue at a subsidiary in a given period may consist of a relatively small number of contracts. Consequently, even small delays in a subsidiary's delivery under a software contract (which may be out of its control) could have a significant and unpredictable impact on consolidated revenue that we can recognize in a given quarterly or annual period. Frequently we recognize consolidated operating losses on a quarterly and annual basis and are likely to do so in the future from time to time. Our operating expenses consist of the aggregate of our four subsidiaries' expenses and the corporate office expenses. Our ChemFree and QS Technologies subsidiaries usually generate an operating profit on an annual basis but our early stage subsidiaries, VISAer and CoreCard, are not consistently profitable, mainly due to significant research and development expense that is invested to complete their new product offerings and the deferral of revenue recognition until such products are delivered to customers. Depending upon the size and number of software licenses recognized in a particular period and the level of expenses incurred to support development and sales activities, our subsidiaries may report operating profits on an irregular basis as they build their customer base. A significant portion of our subsidiaries' expense is related to personnel which is relatively fixed in the short-term and we continually evaluate and strive to balance our financial resources with the resources required to complete products under development and support our subsidiaries' customers. For these and other reasons, our operating profits or losses may vary from quarter to quarter and at the present time are generally not predictable with any degree of certainty.

We also frequently generate income or losses from non-operating sources and we may do so from time to time in the future. Occasionally we derive income from sales of holdings in affiliate and other minority-owned companies or we record a charge if we believe the value of a non-consolidated company is impaired. We also recognize on a quarterly basis our pro rata share of the income or losses of affiliate companies accounted for by the equity method. The timing and amount of gain or loss recognized as a result of a sale or the amount of equity in the income or losses of affiliates generally are not under our control and are not necessarily indicative of future results, either on a quarterly or annual basis.

In recent years, the majority of our cash has been generated on an irregular basis from sales of our investments in early stage technology companies. We have used a significant amount of the cash received from these sales to support the operations of our CoreCard Software and VISAer subsidiaries. We presently believe that customer payments on existing and pending software contracts will be sufficient to fund most of the expenses of VISAer's operations for the foreseeable future and a growing portion of CoreCard's expenses, although any delays in developing or delivering on software and services may increase their need for cash.

## **Results of Operations**

The following discussion should be read in conjunction with the Consolidated Financial Statements and the Notes to Consolidated Financial Statements presented in this quarterly report.

**Revenue** - Total revenue in the three month period ended March 31, 2005 was \$3,579,000, a 22 percent decrease compared to the first quarter of 2004. Revenue from products, which includes sales of equipment in our Industrial Products segment as well as software license fees related to the Information Technology segment, declined by 36 percent from \$3,227,000 in the three months ended March 31, 2004 to \$2,063,000 in the three months ended March 31, 2005. Product revenue from sales of software licenses represented 17 percent of total product revenue in the three months ended March 31, 2005 compared to 49 percent of total product revenue in the three months ended March 31, 2004. The decrease in product revenue is due mainly to fact that in the first quarter of last year, our

CoreCard subsidiary recognized \$1,377,000 in software license revenue due to completion of its first major customer installation in early 2004. There was no such installation completed in the first quarter of 2005. The decline in software license revenue period-to-period was offset in part by a three percent overall increase in product revenue at ChemFree, reflecting continued growth in Europe in sales of ChemFree's machines and supplies, a slight decline in domestic sales of machines and an increase in domestic revenue from leased machines and fluid supplies. Service revenue increased period-to-period by nine percent, or \$131,000, reflecting more maintenance and professional services delivered by each of our three software subsidiaries. The increase in service revenue is due to a larger base of installed customers at each of our software subsidiaries that pay annual maintenance fees and that require other billable professional services.

**Table of Contents**

**Cost of Sales** - In the three month period ended March 31, 2005, total cost of sales was 48 percent of total revenue compared with 39 percent of total revenue in the same three month period in 2004. Cost of product revenue was 42 percent of product revenue in the first quarter of 2005 compared to 31 percent of product revenue in the same period in 2004. The principal reason for the difference is due to a change in product mix between periods. Software license revenue, which has a low cost of sales compared to the ChemFree industrial products, represented 49 percent of product revenue in the three month period ended March 31, 2004 compared to 17 percent of product revenue in the corresponding period in 2005. The cost of product sales for ChemFree products was lower in the first quarter of 2005 as compared to the first quarter of last year reflecting reductions in the cost of direct materials and lower payroll costs. Cost of service revenue (which relates to the software subsidiaries only) was 57 percent and 58 percent in the three month periods ending March 31, 2005 and 2004, respectively.

**Operating Expenses** - In the three month period ended March 31, 2005, total consolidated operating expenses decreased by 14 percent compared to the corresponding period in 2004. Consolidated marketing expenses were 18 percent (\$119,000) lower in the first quarter of 2005 as compared to last year, the majority of which reflects reduced sales personnel and travel expenses at our VISAer subsidiary. Consolidated general and administrative expenses increased by seven percent (\$65,000) in the three month period ended March 31, 2005 as compared to the corresponding period in 2004 due to a combination of minor miscellaneous items. Consolidated research and development expenses were 23 percent (\$473,000) lower in the first quarter of 2005 compared to the first quarter of 2004. Three quarters of the decline reflects lower expenses at VISAer due mainly to the allocation of more personnel cost to billable professional services and the use of fewer third party contractors. The balance of the reduction in R&D expense represents mainly a reduction in the number of domestic employees at CoreCard and increased allocation of personnel expense to the cost of professional services at QS Technologies.

**Interest Income (Expense)** - In the three months ended March 31, 2005, we recorded \$6,000 in net interest income compared to \$3,000 in interest expense in the corresponding period in 2003. The net interest income in 2005 includes interest income recorded at a subsidiary reflecting a finance charge on a customer contract, offset in part by approximately \$3,000 in interest expense related to the company's borrowings under its bank line of credit.

**Investment Income** - We recorded investment income of \$1,042,000 in the first quarter of 2005 compared to no investment gain or loss in the three months ended March 31, 2004. The investment income in 2005 reflects a third cash distribution received in the first quarter of 2005 related to the ISC Guernsey asset sale completed in June 2004, as explained more fully in Note 2 to our 2004 Form 10-KSB.

**Equity Earnings (Losses) of Affiliate Companies** - On a quarterly basis, we recognize our pro rata share of the earnings or losses of affiliate companies that we record on the equity method. We recorded \$17,000 in net equity in income of affiliate companies in the first quarter of 2005 compared to \$38,000 in net equity in losses of affiliate companies in the three months ended March 31, 2004. These results include our pro rata share of the net earnings and losses reported by two affiliate companies (CoreXpand and Horizon Software) in 2005 and five affiliate companies (CoreXpand, Horizon Software, Alliance Technology Ventures, Riverside Software and Cirronet) in 2004. The change between periods reflects mainly an improvement in the financial results of affiliate company, Horizon Software.

**Other Income, Net** - Other income was \$8,000 and \$59,000 in the three months ended March 31, 2005 and 2004, respectively. The 2005 amount reflects foreign currency exchange gains and in 2004, the amount includes recognition of deferred gain of \$34,000 related to a prior period sale of a VISAer product line and \$25,000 in other miscellaneous income, mainly foreign currency exchange gains.

**Income Taxes** - In the three months ended March 31, 2005, the tax liability recorded reflects \$4,000 in state tax liability at a subsidiary and \$8,000 in estimated alternative minimum tax. We did not accrue for any other income tax

liability year-to-date in 2005 and we believe our deferred tax assets should be fully reserved given their character and our historical losses.

### **Liquidity and Capital Resources**

Our cash balance at March 31, 2005 was \$1,632,000, an increase of \$962,000 compared to our cash balance at December 31, 2004. Our principal sources of cash during the three month period ended March 31, 2005 were a \$1,042,000 cash distribution related to the previously reported ISC Guernsey transaction, a decrease of \$389,000 in accounts receivable mainly related to collections at the QS Technologies subsidiary on an unusually high balance of accounts receivable at year-end 2004, and an increase in deferred revenue of \$851,000 representing primarily customer payments at VISAer in advance of revenue recognition. Our principal uses of cash during the three months ended March 31, 2005 were approximately

## **Table of Contents**

\$900,000 to support the operations of our VISAer and CoreCard subsidiaries, approximately \$260,000 in corporate office expense and \$136,000 to reduce the principal amount of bank debt outstanding.

During the quarter, the carrying value of unrealized investment losses, a component of accumulated other comprehensive loss in stockholders' equity, changed by \$109,000 due to a decline in the trading price of our holdings of common stock in Anadigics, Inc. [ANAD:NASDAQ].

We have several potential near-term sources of cash to support any negative cash flow from consolidated operations, including periodic draws against our bank line of credit and a potential additional cash distribution of as much as \$1 million related to the ISC Guernsey transaction, although the amount and timing of any distribution will be based on the business needs and opportunities available to ISC Guernsey, over which we do not exert control. We believe there is sufficient availability under our line of credit if needed to support any short-term timing differences in consolidated cash flows which may occur from time to time and to provide for our cash requirements for at least the next twelve months.

Beyond 2005, we expect that our liquidity will continue to improve and consolidated operations will generate sufficient cash to fund their requirements, with the use of our credit facility to accommodate short-term needs. Other long-term sources of liquidity include potential sales of investments, subsidiaries or assets, although the timing and amounts of any such transactions are uncertain and generally not predictable far in advance. We do not currently have any off balance sheet arrangements that are reasonably likely to have a current or future material effect on our financial condition, liquidity or results of operations.

## **Critical Accounting Policies and Estimates**

The discussion and analysis of our financial condition and results of operations is based upon our consolidated financial statements which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amount of assets, liabilities, revenues and expenses. We consider certain accounting policies related to revenue recognition, valuation of acquired intangibles and impairment of long-lived assets, and valuation of investments to be critical policies due to the estimation processes involved in each. Management discusses its estimates and judgments with the Audit Committee of the Board of Directors. For a detailed description on the application of these and other accounting policies, see Note 1 to the Consolidated Financial Statements contained in our annual report on Form 10-KSB for the fiscal year ended December 31, 2004. Reference is also made to the discussion of the application of these critical accounting policies and estimates contained in Management's Discussion and Analysis in our annual report on Form 10-KSB for 2004. During the quarter ended March 31, 2005, there were no significant or material changes in the application of critical accounting policies that would require an update to the information provided in the Form 10-KSB for 2004.

## **Factors That May Affect Future Operations**

Future operations are subject to risks and uncertainties that may negatively impact our future results of operations or projected cash requirements. It is difficult to predict future quarterly and annual results with any certainty mainly because several of our subsidiaries are early stage companies with limited revenue and experience in their respective markets, all are relatively small in size and, particularly for our software subsidiaries, revenue tends to be associated with fewer and larger sales than for our industrial products subsidiary. Thus any trend or delay that affects even one of our subsidiaries could have a negative impact on the company's consolidated results of operations or cash requirements on a quarterly or annual basis. In addition, the carrying value of our investments is impacted by a number of factors which are generally beyond our control since we are typically a non-control shareholder in a private company with limited liquidity. Among the numerous factors that may affect our consolidated results of operations or financial

condition are the following:

Delays in software development projects which could cause our customers to delay implementations, delay payments or cancel contracts, which would increase our costs, reduce our revenue and increase our cash requirements.

Undetected software errors which may delay product releases, increase our costs, result in non-acceptance of our software by customers or delay revenue recognition.

Competitive pressures (including pricing, changes in customer requirements and preferences, and competitor product offerings) which may cause prospective customers to choose an alternative product solution, resulting in lower revenue and profits (or increased losses).

Page 10

---

**Table of Contents**

The inability of our CoreCard or VISAer subsidiaries to establish a base of referenceable customers for their new product offerings, resulting in lower revenue and profits (or increased losses), increased cash needs and possibly leading to restructuring or cutting back of the subsidiary's operations.

Failure of our products' specifications and features to achieve market acceptance.

Delays in anticipated customer payments for any reason which would increase our cash requirements and possibly our losses.

Declines in performance, financial condition or valuation of minority-owned companies which could cause us to write-down the carrying value of our investment or postpone an anticipated liquidity event, which could negatively impact our earnings and cash.

A reversal of the improving trend in the commercial aviation industry worldwide which could impact VISAer's near-term customer purchases, thus increasing its losses and need for cash.

The relatively limited sales and marketing experience of our VISAer and CoreCard subsidiaries in their respective markets could cause them to misinterpret or fail to interpret or adjust to a trend in the market or to underestimate the sales cycle time frame.

In the Industrial Products market, failure by ChemFree to achieve anticipated growth in the European market or to reverse the recent decline in sales through its domestic distributor network cause lower than anticipated sales and profits.

An insufficient number of potential CoreCard customers decide to purchase and run an in-house software system and instead choose to outsource their account transaction processing which could result in lower revenue, increased costs and greater cash requirements.

Budget reductions by state and local governments for information technology products that delay award of contracts or implementations for our QS Technologies subsidiary.

Other general economic and political conditions, particularly those which may cause international business and domestic government customers to delay or cancel software purchase decisions.

**Item 3. Controls and Procedures**

As of the end of the period covered by this report, the company carried out an evaluation, under the supervision and with the participation of the company's management, including the Company's Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of the company's disclosure controls and procedures pursuant to Rule 13a-15(b) under the Exchange Act. Based upon that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that the company's disclosure controls and procedures are effective. There were no changes in the company's internal controls over financial reporting or in other factors identified in connection with this evaluation that occurred during the period covered by this report that have materially affected, or are reasonably likely to materially affect, the company's internal control over financial reporting.

**Table of Contents**

**Part II. OTHER INFORMATION**

**Item 6. Exhibits**

The following exhibits are filed or furnished with this report:

- 3(i) Amended and Restated Articles of Incorporation of the Registrant dated November 14, 1991, as amended November 25, 1997. (Incorporated by reference to Exhibit 3.1 to the Registrant's Annual Report on Form 10-K for the year ended December 31, 1991 and to Exhibit 3.1 to the Registrant's Report on Form 8-K dated November 25, 1997.)
- 3(ii) Bylaws of the Registrant dated June 6, 1997. (Incorporated by reference to Exhibit 3(ii) of the Registrant's Form 10-K/A for the year ended December 31, 1997.)
- 4.1 Rights Agreement dated as of November 25, 1997 between the Registrant and American Stock Transfer & Trust Company as Rights Agent. (Incorporated by reference to Exhibit 4.1 of the Registrant's Report on Form 8-K dated November 25, 1997 and filed on December 16, 1997.)
- 4.2 Form of Rights Certificate. (Incorporated by reference to Exhibit 4.2 of the Registrant's Report on Form 8-K dated November 25, 1997 and filed on December 16, 1997.)
- 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 of Chief Executive Officer and Chief Financial Officer furnished as required by Section 906 of the Sarbanes-Oxley Act of 2002.

**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, hereunto duly authorized.

INTELLIGENT SYSTEMS CORPORATION  
Registrant

Date: May 13, 2005

By: */s/ J. Leland Strange*

J. Leland Strange  
Chief Executive Officer, President

Date: May 13, 2005

By: */s/ Bonnie L. Herron*

Bonnie L. Herron  
Chief Financial Officer