IMAGE SOFTWARE INC
Form 10-Q
May 13, 2005

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

|X| QUARTERLY REPORT PURSUANT TO SECTION 13 OF 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934. For the quarterly period ended 3/31/2005

OR

|_| TRANSITION REPORT PURSUANT TO SECTION 13 OF 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934. For the transition period from ________ to ________

1mage Software, Inc.
(Exact name of Registrant as specified in its charter)

0-12535
(Commission File Number)

Colorado	84-0866294
(State of Incorporation)	(IRS Employer Identification Number)
6025 S. Quebec St. Suite 300 Englewood CO 80111	(303) 694-9180
(Address of principal executive offices)	(Registrant's telephone number, including area code)

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

Indicate by check mark whether the Registrant is an accelerated filer (as defined in Rule 12b-2 of the Act). Yes |_| No |X|

As of May 6, 2005, there were 3,302,597 shares of the Registrant's Common Stock outstanding.

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PART I - FINANCIAL INFORMATION

ITEM 1. Financial Statements

1mage Software, Inc.
BALANCE SHEETS

ASSETS	Unaudited March 31, 2005	December 31, 2004
CURRENT ASSETS:		
Cash and cash equivalents	$ 190,281	$ 50,503
Receivables:		
Trade (less allowance: 2005, $3,750; 2004, $20,000)	187,104	81,851
Other	25,000	
Prepaid expenses and other current assets	6,815	2,033
Inventory	4,878	5,756
Employee advances	348	393
Total current assets	414,426	140,536
PROPERTY AND EQUIPMENT, at cost, net	29,728	33,816
OTHER ASSETS:		
Software development costs, net	668,704	680,613
Loan costs, net	4,329	8,649
Rent/security deposit	7,841	7,841
TOTAL ASSETS	$ 1,125,028	$ 871,455
LIABILITIES AND SHAREHOLDERS' EQUITY (DEFICIT)		
CURRENT LIABILITIES:		
Line of credit- bank	$ 162,300	$ 172,300
Current portion of capital lease obligations	4,124	4,124
Deferred revenue	302,865	310,403
Accounts payable	122,541	60,002
Accrued liabilities	345,989	370,040
Total current liabilities	937,819	916,869
LONG-TERM OBLIGATIONS:		
Capital lease obligations	4,375	5,311

Deferred rent	11,930	12,636
Line of credit-Related Parties, net of discount	393,273	197,772
	409,578	215,719
SHAREHOLDERS' EQUITY (DEFICIT):		
Common stock, $.004 par value - 10,000,000 shares authorized; shares outstanding: 2005 and 2004: 3,302,597	13,210	13,210
Additional paid-in capital	7,421,601	7,361,988
Accumulated deficit	(7,657,180)	(7,636,331)
Total shareholders' equity (deficit)	(222,369)	(261,133)
TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY (DEFICIT)	$ 1,125,028	$ 871,455

See Notes to Condensed Financial Statements

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1mage Software, Inc.
STATEMENTS OF OPERATIONS
(Unaudited)

	Three Months Ended March 31,	
	2005	2004
REVENUE		
System sales and software licenses	$ 172,056	$ 156,007
Services and annual fees	234,085	287,737
Total revenue	406,141	443,744
COST OF REVENUE		
System sales and software licenses	111,700	102,265
Services and annual fees	86,088	138,051
Total cost of revenue	197,788	240,316
GROSS PROFIT	208,353	203,428
% of Revenue	51%	46%
OPERATING EXPENSES:		
Selling, general & administrative	200,043	349,269
INCOME/(LOSS) FROM OPERATIONS	8,310	(145,841)
OTHER INCOME/(EXPENSE):		
Interest expense	(29,590)	(9,104)
Interest income	399	82
Other income	32	--
Total other income (expense)	(29,159)	(9,022)

LOSS BEFORE INCOME TAXES	(20,849)	(154,863)
PROVISION FOR INCOME TAXES	--	--
NET LOSS	$ (20,849)	$ (154,863)
BASIC AND DILUTED LOSS PER COMMON SHARE:	$ (.01)	$ (.05)
WEIGHTED AVERAGE NUMBER OF COMMON SHARES OUTSTANDING:	3,302,597	3,287,597

See Notes to Condensed Financial Statements

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1mage Software, Inc.
STATEMENTS OF CASH FLOWS
(Unaudited)

	Three Months Ended March 31,	
	2005	2004
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net Earnings/(Loss)	$ (20,849)	$ (154,863)
Adjustments to reconcile earnings to net cash provided by operating activities:		
Depreciation and amortization	74,338	84,093
Amortization of deferred loan costs	4,320	--
Amortization of debt discount	16,664	--
Deferred rent	(706)	--
Deferred revenue	(7,538)	(10,000)
Changes in assets and liabilities:		
Receivables	(130,253)	(21,243)
Inventory	878	(3,532)
Prepaid expenses and other assets	(4,737)	32,180
Accounts payable	62,539	(27,627)
Accrued liabilities	(24,051)	(13,775)
Net cash used for operating activities	(29,395)	(114,767)
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchase of property and equipment	--	(2,963)
Additions to capitalized software	(58,341)	(65,286)
Net cash used for investing activities	(58,341)	(68,249)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Repayment of line of credit- Bank	(10,000)	--

Additions to the line of credit- Bank	--	50,686
Additions to the line of credit- Related Party	238,450	50,000
Principal payments under capital lease obligations	(936)	(702)
Net cash provided by (used for) financing activities	227,514	99,984
DECREASE IN CASH AND CASH EQUIVALENTS	139,778	(83,032)
CASH AND CASH EQUIVALENTS, beginning of period	50,503	143,505
CASH AND CASH EQUIVALENTS, end of period	$ 190,281	$ 60,473
SUPPLEMENTAL CASH FLOWS INFORMATION		
Beneficial conversion option associated with DEMALE line of credit	$ 59,613	$ --
Capital lease obligation incurred for purchase of equipment	$ --	$ 1,993

See Notes to Condensed Financial Statements

1mage Software, Inc.
NOTES TO INTERIM FINANCIAL STATEMENTS

GENERAL:

Management has elected to omit substantially all notes to the unaudited interim financial statements. Reference should be made to the Company's annual report on Form 10-K for the year ended December 31, 2004 as this report incorporates the Notes to the Company's year-end financial statements. The condensed balance sheet of the Company as of December 31, 2004 has been derived from the audited balance sheet of the Company as of that date.

UNAUDITED INTERIM INFORMATION:

The unaudited interim financial statements contain all necessary adjustments (consisting of only normal recurring adjustments), which, in the opinion of Management, are necessary for a fair statement of the results for the interim periods presented. The results of operations for the interim periods presented are not necessarily indicative of those expected for the year.

Revenue Recognition - Revenue from the sale of software licenses, computer equipment, and existing application software packages is recognized when the software and computer equipment are shipped to the customer, remaining vendor obligations are insignificant, there are no significant uncertainties about customer acceptance and collectibility is probable. Revenue from related services, including installation and software modifications, is recognized upon performance of services. Maintenance revenue is recognized ratably over the maintenance period.

Income Taxes - The Company follows the liability method of accounting for income taxes in accordance with Statement of Financial Accounting Standards (SFAS) No. 109. Under this method, deferred income taxes are recorded based upon differences between the financial reporting and tax bases of assets and liabilities and are measured using enacted tax rates and laws that will be in effect when the underlying assets or liabilities are received or settled.

The Company has recorded a valuation allowance against the deferred tax assets due to the uncertainty of ultimate realizability.

Earnings (Loss) Per Share - Earnings/ (Loss) per share is computed by dividing net income (loss) by the weighted average number of common and equivalent shares outstanding during the period. Outstanding stock options are treated as common stock equivalents for purposes of computing diluted earnings per share. As the Company incurred a net loss for the periods ended March 31, 2005 and 2004, the outstanding stock options and stock purchase warrants were antidilutive and have been excluded from the computation of diluted earnings per share.

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

	For the three months en March 31	
	2005	2004
Net (loss), as reported	$ (20,849)	$(154,8
Less: Total stock-based employee compensation cost determined under the fair value based method, net of income taxes	(5,420)	(5,8
Pro forma net (loss)	$ (26,269)	$(160,6
Loss per share:		
Basic and Diluted Loss - as reported	$ (0.01)	$ (0.
Basic and Diluted Loss - pro forma	$ (0.01)	$ (0.

Line of Credit - Related Party - On April 1, 2003, the Company entered into a $300,000 revolving line-of-credit agreement (the "Agreement") with DEMALE, LLC, an entity controlled by certain stockholders of the Company. The lender was given the right to convert all or any portion of the unpaid principal and interest owed under the line into shares of the Company's common stock at a conversion price equal to 80% of the fair market value on that date. Effective March 31, 2005, the Agreement was amended to increase the line of credit to $500,000 and to extend the due date until June 30, 2007 or such earlier date as is mutually agreed upon by the Company and DEMALE. The amendment also changed the conversion price for the outstanding principal and interest on the line to $.14 per share, or 80% of the fair market value on the date of the written notice, whichever is lower. At March 31, 2005, there was $462,050 borrowed against this line. The line is secured by substantially all of the Company's assets but is subordinated to the bank line of credit, which holds a senior lien on the same assets. Interest is accrued and payable quarterly at prime plus 1 1/2% (7.25% at March 31, 2005) but may not be less than 7%; therefore, at March 31, 2005, interest was being accrued at 7.25%.

Subsequent Event

In April 2005, the Company filed an appeal from the district court's judgment confirming the award against the Company in the Reynolds and Reynolds arbitration. The appeal was filed with the United States Court of Appeals for the Tenth Circuit and required the Company to file a cash bond for $180,000, which substantially reduced the Company's cash and cash equivalents of $190,000 reported on March 31, 2005.

OVERVIEW

1mage Software, Inc. (the "Company") continues to face the challenge of consistently generating revenues at or above the same level it achieved prior to the termination by Reynolds & Reynolds, Inc., its largest customer. Revenues from the Company's new customers since that time, which would have otherwise represented business growth, have been used instead to sustain operations. Accordingly, the Company has focused on the development of new customers and new markets through its channel partners program, with mixed success.

The Company has developed a new, lower cost, strategy for the distribution of its products and services. The downturn in revenue associated with this change in strategy, however, has required the Company to bring its cost structure in line with its available revenue. As a result, the Company implemented new stringent cost cutting measures throughout 2004 and into 2005 that are expected to help improve its results of operations in 2005.

Despite the lower sales revenue, the Company made a number of positive improvements during the first quarter of 2005. While total revenue decreased 8%, gross profit as a percent of revenue increased, as the Company began to see some positive results from changing its sales model to an independent sales network. By outsourcing consulting services and eliminating related salary expenses, the Company was able to make progress in its goal of returning to profitability by dramatically reducing SG&A expenses. In the first quarter of 2005, the Company improved its bottom line by $134,000 from a year earlier. This improvement occurred notwithstanding a sharp increase in interest expense, due in part to the amortization of the DEMALE debt discount, which was $30,000 for the first quarter of 2005, as compared to $9,000 for the first quarter of 2004. Despite the overall improvement, the Company still reported a $21,000 net loss for the first quarter of the current year, as compared to a $155,000 loss a year ago. Because the Company has limited capital resources, namely a bank line of credit and a private line of credit from its shareholders, it cannot continue to sustain such losses without a seriously adverse effect on its liquidity and operations. Thus, the Company has redoubled its sales efforts and continues to eliminate non-essential expenses as part of its relentless efforts to re-establish profitability.

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

RESULTS OF OPERATIONS FOR THREE MONTHS ENDED MARCH 31, 2005 VERSUS MARCH 31, 2004

The Company reported revenue of $406,000 for the first quarter of 2005, a $38,000 decrease (8%) from $444,000 posted for the first quarter in 2004. This decrease was primarily due to a $49,000 decrease in consulting services revenue that was, in terms of overall profitability, offset by a $62,000 reduction in consulting services salaries. This is a result of the Company's new focus on generating revenue through an independent sales network, rather than selling through its direct sales channels. By utilizing an outside sales network, fixed costs of salaried employees are significantly reduced. Annual license fee revenue of $175,000 for the first quarter was roughly equivalent to the $179,000 reported in 2004. Revenue from hardware sales of $40,000 was $27,000 (209%) higher than the same quarter in 2004. A significant reduction in technical support salaries and related expenses caused gross profit as a percentage of total revenue to increase 5% over last year to 51% of total revenue (versus 46% in first quarter 2004). SG&A expenses of $200,000 were 43% lower than first quarter last year, a decrease of $149,000 from the $349,000 posted a year ago. Expenses were lower for nearly every category, as a result of eliminating all

non-essential expenses. Legal expenses were $47,000 less for the first quarter of 2005, as compared to the first quarter of 2004, on account of the diminished activity in the Reynolds and Reynolds litigation. Interest expense, due in part to the amortization of the DEMALE debt discount, was $30,000 for the first quarter of 2005, a $21,000 (106%) increase from $9,000 recorded in 2004. The combination of lower revenues, reduced operating expenses and higher interest expense caused the Company to incur a net loss of $21,000, or $(.01) per share for the first quarter of 2005 versus a net loss of $155,000 or $(.05) per share for the same quarter a year ago.

LIQUIDITY AND CAPITAL RESOURCES

The Company's cash and cash equivalents of $190,000 increased approximately $140,000 during the three months ended March 31, 2005 as compared to December 31, 2004. Besides the $21,000 loss for the first quarter, the Company used cash of $58,000 for deferred development expenses to offset the additional $238,000 drawn down on the DEMALE line of credit. The Company had deficit working capital of $523,000 as of March 31, 2005, versus deficit working capital of $776,000 as of December 31, 2004. Included in current liabilities is $303,000 for Deferred Revenue, which represents payments on annual maintenance contracts that will be earned over the next twelve months.

The Company had drawn $162,300 on its bank line of credit on March 31, 2005. The $200,000 bank line matured in February 2005 and is collateralized by all accounts receivable and general intangibles of the Company. The Company has negotiated an extension of time to repay the promissory note underlying the bank line of credit, which was due in full on March 31, 2005, until August 15, 2005. During the four and a half month extension, the Company will make payments of principal and interest based on a 48 month amortization schedule. There can be no assurance that the Company will be able to obtain a further extension from the bank or that it will be able to locate alternative sources of capital to pay the entire remaining principal when it falls due on August 15, 2005.

The Company had drawn $462,050 on its line of credit with DEMALE on March 31, 2005. This private line of credit has a limit of $500,000, expires in June 2007 and is secured by a second lien on the same assets as the bank line of credit.

Shortly after the end of the quarter, in April 2005, the Company filed an appeal from the district court's judgment confirming the award against the Company in the Reynolds and Reynolds arbitration. The appeal was filed with the United

States Court of Appeals for the Tenth Circuit and required the Company to file a cash bond for $180,000, which substantially reduced the Company's cash and cash equivalents of $190,000 reported on its March 31, 2005 balance sheet.

The Company receives its revenues from software licenses, recurring annual maintenance/license fees, consulting services and minimal hardware sales. Notwithstanding the burdens and unprecedented hardships imposed by the Reynolds arbitration award and judgment, the Company expects that its continued relationship with DEMALE, and the cash flows generated from current operations, will be sufficient to meet its immediate needs for working capital. There can be no assurance, however, that the Company's expectations in this regard will prove to be accurate or that the Company will be able to continue as a going concern. Moreover, the long-term availability of new capital to the Company remains uncertain.

The Company has no material commitments for capital expenditures for 2005.

Forward Looking Statements

Some of the statements made herein are not historical facts and may be considered "forward looking statements." All forward-looking statements are, of course, subject to varying levels of uncertainty. In particular, statements which suggest or predict future events or state the Company's expectations or assumptions as to future events may prove to be partially or entirely inaccurate, depending on any of a variety of factors, such as adverse economic conditions, new technological developments, competitive developments, competitive pressures, changes in the management, personnel, financial condition or business objectives of one or more of the Company's customers, increased governmental regulation or other actions affecting the Company or its customers as well as other factors.

Item 3. Quantitative and Qualitative Disclosures About Market Risk — Inapplicable

Item 4. Controls and Procedures

Internal Controls

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

There have been no significant changes in the Company's internal controls during the quarter ended March 31, 2005, or in other factors that could significantly affect internal controls subsequent to the date of the evaluation described above.

PART II: OTHER INFORMATION

Item 1. Legal Proceedings

Shortly after the end of the quarter, in April 2005, the Company filed an appeal from the district court's judgment confirming the award against the Company in the Reynolds and Reynolds arbitration. The appeal was filed with the United States Court of Appeals for the Tenth Circuit and required the Company to file a $180,000 cash bond pending appeal.

Item 2.	Changes in Securities and Use of Proceeds	Inapplicable
Item 3.	Defaults Upon Senior Securities	Inapplicable
Item 4.	Submission of Matters to a Vote of Security Holders	Inapplicable
Item 5.	Other Information	Inapplicable

Item 6. Exhibits

Exhibit Table

31.1 Certificate of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

31.2 Certificate of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

32 Certificate of CEO and CFO pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

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.

1mage Software, Inc.
(Registrant)

Date: 5/13/2005 /s/ David R. DeYoung

David R. DeYoung
President, Principal and Chief Executive Officer

Date: 5/13/2005 /s/ Mary Anne DeYoung

Mary Anne DeYoung
Vice President, Finance and Principal Financial Officer