MAI SYSTEMS CORP
Form 10-Q
August 23, 2004

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, DC 20549

FORM 10-Q

ý Quarterly report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934.

For the period ended June 30, 2004 or

o Transition report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934.

For the transition period from to .

Commission file number: 1-9158

MAI Systems Corporation

(Exact name of registrant as specified in its charter)

Delaware	**22-2554549**
(State or other jurisdiction of incorporation or organization)	**(IRS Employer Identification No.)**

26110 Enterprise Way, Lake Forest, CA 92630
Address of principal executive offices

Registrant s telephone number including area code (949) 598-6000

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 ý No o

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act).

Yes o No ý

The aggregate market value of the common stock held by non-affiliates of the registrant, based upon the last sale price of the Common Stock reported on the National Association of Securities Dealers Automated Quotation National Market System on August 5, 2004 was $2,494,877.84.

The number of shares of common stock issued, outstanding and subscribed as of August 5, 2004 was 14,675,752.

PART I - FINANCIAL INFORMATION

Item 1. Financial Statements

MAI SYSTEMS CORPORATION

CONDENSED CONSOLIDATED BALANCE SHEETS

(Unaudited)

	(in thousands, except share data)	
	As of December 31, 2003	**As of June30, 2004**
ASSETS		
Current assets:		
Cash	$ 664	$ 129
Receivables, less allowance for doubtful accounts of $335 in 2003 and $434 in 2004	1,313	2,009
Inventories	47	50
Prepaids and other assets	814	800
Total current assets	2,838	2,988
Furniture, fixtures and equipment, net	758	623
Intangibles, net	2,876	3,480
Other assets	58	140
Total assets	$ 6,530	$ 7,231
LIABILITIES AND STOCKHOLDERS DEFICIENCY		
Current liabilities:		
Current portion of long-term debt	$ 3,646	$ 914
Accounts payable	904	1,157
Customer deposits	2,334	1,463
Accrued liabilities	3,059	2,422
Income taxes payable	85	99
Unearned revenue	3,209	4,787
Total current liabilities	13,237	10,842

Long-term debt		7,135		10,286
Other liabilities		744		480
Total liabilities		21,116		21,608
Commitments and contingencies				
Stockholders deficiency:				
Preferred Stock, par value $0.01 per share; 1,000,000 shares authorized, none issued and outstanding				
Common Stock, par value $0.01 per share; authorized 24,000,000 shares; 14,875,752 and 14,675,752 shares issued,outstanding and subscribed at December 31, 2003 and June 30, 2004, respectively.		152		152
Additional paid-in capital		218,112		218,112
Accumulated other comprehensive loss				
Minimum pension liability		(1,005)		(1,005)
Foreign currency translation		(2)		(60)
Unearned Compensation		(53)		(34)
Accumulated deficit		(231,790)		(231,542)
Total stockholders deficiency		(14,586)		(14,377)
Total liabilities and stockholders deficiency	$	6,530	$	7,231

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

MAI SYSTEMS CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

	(Unaudited) For the Three Months Ended June 30,		(Unaudited) For the Six Months Ended June 30,	
	2003	2004	2003	2004
	(in thousands, except per share data)		(in thousands, except per share data)	
Revenue:				
Software	$ 1,127	$ 814	$ 2,257	$ 2,103
Network and computer equipment	86	136	235	211
Services	3,539	3,951	7,446	7,760
Total revenue	4,752	4,901	9,938	10,074
Direct costs:				
Software	52	8	258	329
Network and computer equipment	74	109	165	169
Services	1,100	1,113	2,274	2,182
Total direct costs	1, 226	1,230	2,697	2,680
Gross profit	3,526	3,671	7,241	7,394
Selling, general and administrative expenses	2,438	2,351	4,969	4,700
Research and development costs	658	908	1,340	1,800
Other operating (income) loss	3	15	(46)	18
Operating income	427	397	978	876
Interest income			1	
Interest expense	(292)	(288)	(642)	(579)
Other non-operating expense	(212)	(23)	(212)	(39)
Income (loss) before income taxes	(77)	86	125	258
Income tax benefit (expense)	(5)	(4)	54	(10)
Net income (loss)	$ (82)	$ 82	$ 179	$ 248
Income (loss) per share:				
Net income per share:				
Basic income (loss) per share	$ (0.01)	$ 0.01	$ 0.01	$ 0.02
Diluted income (loss) per share	$ (0.01)	$ 0.01	$ 0.01	$ 0.02

Weighted average common shares used in determining income (loss) per share:				
Basic	14,426	14,676	14,426	14,676
Diluted	14,426	14,676	14,726	14,676

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

MAI Systems Corporation

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

	For the Six Months Ended June 30,	
	2003	**2004**
	(in thousands)	
Net cash provided by operating activities:	$ 399	$ 605
Cash flows used in investing activities:		
Proceeds from note receivable	250	
Capital Expenditures	(195)	(110)
Capitalized software development costs	(419)	(604)
Net cash used in investing activities	(364)	(714)
Cash flows used in financing activities:		
Repayments on long-term debt	(148)	(425)
Net cash used in operations	(113)	(534)
Effect of exchange rate changes on cash	(3)	(1)
Net change in cash	(116)	(535)
Cash at beginning of period	545	664
Cash at end of period	$ 429	$ 129

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

MAI Systems Corporation

Notes to Condensed Consolidated Financial Statements

Three Months ended June 30, 2004

(Unaudited)

1. Basis of Presentation

Companies for which this report is filed are MAI Systems Corporation and its wholly owned subsidiaries (the Company). The information contained herein is unaudited, but gives effect to all adjustments (which are normal recurring accruals) necessary, in the opinion of Company management, to present fairly the condensed consolidated financial statements for the interim period. All significant intercompany transactions and accounts have been eliminated in consolidation.

Although the Company believes that the disclosures in these financial statements are adequate to make the information presented not misleading, certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted pursuant to the rules and regulations of the Securities and Exchange Commission (the SEC), and these financial statements should be read in conjunction with the financial statements included in the Company s Annual Report on Form 10-K for the year ended December 31, 2003, which is on file with the SEC.

2. Liquidity

Although the Company has a net stockholders deficiency of $14,377,000 and a working capital deficit of $7,854,000 at June 30, 2004, the Company expects to generate positive cash flow from its operations during 2004 from shipping out products and services from its current backlog as of June 30, 2004 as well as new orders and through its proposed private placement of $1 million from an Investor Group to meet its operating and capital requirements (see Note 5). In the event that the Company cannot generate positive cash flow from its operations during 2004, the Company can substantially reduce its research and development efforts to mitigate cash outflow to help sustain its operations. There can be no assurance that the Company will be able to sustain profitability, generate positive cash flow from operations or restructure its debt as necessary. These financial statements have been prepared assuming the Company will continue to operate as a going concern. If the Company is unsuccessful in the aforementioned efforts, the Company could be forced to liquidate certain of its assets, reorganize its capital structure and, if necessary, seek other remedies available to the Company, including protection under the bankruptcy laws.The restructured debt, pursuant to the original inter-creditor agreement between Canyon Capital and Coast, which was sold to Wamco on May 15, 2003, contains various restrictions and covenants. In the event that the Company were not in compliance with the various restrictions and covenants and were unable to receive waivers for non-compliance, the term debt would be immediately due and payable. The Company is not in compliance with the amended debt covenants as of and for the period ending June 30, 2004. There is no guaranty that the Company will meet its debt covenants in the future. In the event that the Company were not in compliance with the various restrictions and covenants and were unable to receive waivers for non-compliance, the term loan would be immediately due and payable.

3. Inventory

Inventories are summarized as follows:

	(dollars in thousands)	
	December 31, 2003	June 30, 2004
Finished goods	$ 39	$ 43
Replacement parts	8	7
	$ 47	$ 50

4. Business Acquisitions

Hospitality Services & Solutions

On June 23, 2002, the Company acquired substantially all of the assets and assumed certain liabilities of Hospitality

Services & Solutions (HSS) including a 35% ownership in AMDB HIS (AMDB) pursuant to a stock purchase agreement for 100,000 shares of common stock valued at $32,000 (the quoted market price of the common stock at the time the terms were agreed), and $75,000 in cash. Additionally, the shareholders of HSS received a 20% minority interest in the Company s combined operations in Asia. HSS was acquired for the Company to expand its operations in the Asian marketplace, strengthen its management team in the territory and create new opportunities for its new enterprise capable suite of products. The net assets acquired from HSS are used in the business of software design, engineering and service relating to hotel information systems. The net assets also include subsidiaries of HSS in Malaysia, Singapore and Thailand. The Company recorded $297,000 of goodwill (deductible for tax purposes) in connection with the acquisition of HSS. Pro forma results of operations as if this acquisition had occurred at the beginning of 2001 and 2002 are not shown because its impact would have been immaterial.

Included in the acquired assets of HSS was a 35% interest in AMDB, an online reservation service, originally purchased by HSS for $66,000. On February 20, 2003, the Company entered into an agreement whereby it acquired the remaining 65% for $79,000 payable over 6 month installments. The net liabilities of $15,000 acquired are used to support an online reservation service related to hotel information systems. The Company recorded $159,000 of goodwill in connection with the acquisition of AMDB. Pro forma results of operations as if this acquisition had occurred at the beginning of 2002 and 2003 are not shown because its impact would have been immaterial.

5. Long-Term Debt

Wamco 32 Ltd.

On January 13, 2003, the Company re-negotiated the terms of its credit facility with Coast Business Credit (Coast) whereby the outstanding balance of $1,828,000 was converted to a term loan which accrues interest at 9.25% per annum and requires monthly payments of $58,000 over a 36 months period commencing March 1, 2003. On February 7, 2003, the Federal Deposit Insurance Corporation (FDIC) put Coast and its parent company, Southern Pacific Bank, into receivership and held all of Coast s assets for sale to third parties. On May 15, 2003, the loan was sold to Wamco 32, Ltd. (Wamco). This sale of the loan by the FDIC did not change any of the terms of the Company s loan agreement. The Company is required to pay Wamco additional principal payments on a quarterly basis based upon an EBITDA-based formula commencing March 31, 2003. For the period ended June 30, 2004, there are no additional principal payments required under the EBITDA-based formula.

On April 9, 2004, the Company successfully re-negotiated the terms of its loan whereby the maturity date was extended to February 28, 2006. In addition, various restrictions and covenants, pursuant to the inter-creditor agreement between Canyon and Wamco, were amended to modify the financial covenants to a minimum quick ratio of 0.20 to 1.00 and a minimum debt coverage ratio of 0.50 to 1.00 effective for the three month period ended March 31, 2004 and for each and every fiscal quarter ending thereafter. The Company was not in compliance with the amended debt covenants as of and for the period ending June 30, 2004, but obtained a waiver for non-compliance. There is no guaranty that the Company will meet its debt covenants in the future. In the event that the Company were not in compliance with the various restrictions and covenants and were unable to receive waivers for non-compliance, the term loan would be immediately due and payable. As of December 31, 2003 and June 30, 2004, the balance of the term loan was $1,366,000 and $1,027,000 respectively.

Canyon Capital Management LP

On January 13, 2003, the Company modified its 11% subordinated notes payable agreement with Canyon Capital Management LP (Canyon), whereby the Company is required to make monthly interest payments of $52,000 until the Wamco term loan is paid off in full at which time the

note payable will be converted into a three-year amortizing loan which will accrue interest at 11% per annum and requires equal monthly payments of principal and interest such that the subordinated debt will be paid in full at the end of the amended term. Upon the repayment of the Wamco debt in full, the Company will also be required to pay Canyon additional principal payments on a quarterly basis based upon an EBITDA-based formula. Additionally, the Company issued to Canyon 200,000 shares of its common stock valued at $20,000 (the quoted market price of the common stock at the time the terms were agreed) and agreed to issue one million warrants at an exercise price of $0.40 per share valued at $42,000 (using the Black-Scholes option-pricing model with the following weighted-average assumptions: risk-free interest rate of 6.5%, volatility of 80% and an expected life of 5 years). The $62,000 is being amortized to interest expense over the term of the modified note. The principal balance outstanding on the subordinate notes payable to Canyon was approximately $5,662,000 at December 31, 2003 and June 30, 2004.

CSA Private Limited

In connection with a settlement agreement in February 2001 with CSA Private Limited (CSA), the Company issued $2.8 million of subordinated debt to CSA. The $2.8 million of debt was secured by all of the Company s assets, which was subordinate to Wamco and Canyon, accrued interest at 10% per annum and required payments of $37,500 from March 1, 2002 through September 1, 2002 and monthly payments of $107,500 commencing on October 1, 2002 until October 2003 when all remaining unpaid principal and accrued interest was to be paid in full.

The agreement with CSA was amended whereby the Company was required to make payments under the subordinated note unless and until it paid $1 million by December 31, 2002. Upon payment of the $1 million, contractual payments under the subordinated note would have ceased until a final payment in the amount of $400,000 is paid by February 28, 2003. If the Company did not make all of the modified payments to CSA, the subordinated note would revert back to its original terms. The Company did not make the modified payment and have not made any payments since September 2002. CSA did not formally notify the Company of its default.

On April 9, 2004, the Company successfully amended its agreement with CSA whereby the principal balance and accrued interest through March 31, 2004, totaling $3,633,000, were converted to two new notes. The first note for $500,000 accrues interest at 10% per annum and provides for monthly payments of $10,000 until the Wamco and Canyon debt is paid in full. Thereafter, the note provides for monthly payments in an amount equal to the greater of i) $10,000 or ii) the amount required to fully amortize all remaining principal and interest in 24 equal monthly payments. The second note for $3,133,000 (Other note) also accrues interest at 10% per annum and provides for monthly payments of $7,500, or such other interest amount, not to exceed $10,000 per month, that Wamco and Canyon will allow. Under the terms of the amended subordination agreement between Wamco, Canyon and CSA, all payments under the new notes are subordinated to the payment in full of the Wamco and Canyon loan agreements. The company has not made any payments on the two new notes as of June 30, 2004. The Company is currently in default of the first note. The interest rate has been increased to 12.5% in line with the terms of that note until the Company becomes current on its contractual payments.

On April 9, 2004, an investor group, consisting of Canyon, the Company s Chairman of the Board, Chief Executive Officer and Chief Financial and Operating Officer (Investor Group), acquired 2,433,333 shares of the Company s common stock held by CSA and the Other Note for $1 million in cash.

Subject to shareholder approval, the Investor Group has agreed to convert the Company indebtedness acquired from CSA plus any accrued interest through the date of shareholder approval for approximately 32,000,000 shares of the Company s common stock based upon a conversion price of $0.10 per share, and will invest $1,000,000 of new cash proceeds into the Company in a private placement at $0.10 per share and receive 10,000,000 shares of the Company s common stock. This Investor Group transaction is subject to certain terms and conditions, including the fact that it will initially be restricted stock, not available for sale. The Company has also received a fairness opinion from Marshall Stevens which concluded that the transaction was fair to the shareholders. The Company s annual shareholders meeting is expected to occur in September 2004. The Investor Group has consented to defer any payments on the other note until the annual shareholder meeting at which time, if approved all principals and accrued interest will be converted to common stock.

Tax Claims

On September 30, 2003, the Company entered into a settlement agreement with the United States Internal Revenue Service (the Service) on a tax claim which resulted from the Company s 1993 Chapter 11 proceedings whereby it agreed to pay $489,000 in equal monthly installments of $7,438 over a period of six (6) years at an interest rate of 6%. The $489,000 settlement is reflected as debt in the financial statements and resulted in a one-time gain of $262,000 which was included in income tax benefit in the fourth quarter of 2003. In the event that the Company fails to pay the Service any payment, and such payment failure continues for sixty days after written notice of such failure, $1,832,100, plus accrued interest thereon, less any payments made by the Company will be immediately due and payable to the Service. As of December 31, 2003 and June 30, 2004, the debt balance was $428,000 and $396,000, respectively.

In connection with the settlement agreement with the Service, the Company s 1993 Chapter 11 proceedings were officially closed pursuant to Court order effective as of September 30, 2003.

6. Restricted Stock Plan

In May 2001, the Board of Directors adopted the 2001 Restricted Stock Plan. Under the plan, 1,250,000 authorized shares of the Company s Common Stock are reserved for issuance to officers and directors of the Company. The shares will be issued as Restricted Stock within the meaning of Rule 144 of the Securities Act of 1933, as amended. The

Compensation Committee of the Board of Directors shall have the discretion to determine what terms and conditions shall apply, including the imposition of a vesting schedule.

In May 2002, the Company issued 612,500 shares of restricted common stock to its members of the board of directors and certain of its corporate officers which vest equally over a four-year period. Recipients are not required to provide consideration to the Company other than rendering the service and have the right to vote the shares. Under APB 25, compensation cost is recognized for the fair value of the restricted stock awarded, which is its quoted market price at the date of grant, which was $0.25 per share. The total market value of the shares of $153,000 was treated as unearned compensation and is being amortized to expense in proportion to the vesting schedule. The unamortized balance as of June 30, 2004 is $34,000 and is included in accumulated other comprehensive loss in the accompanying consolidated balance sheet.

7. Preferred Stock

On May 20, 1997, the Company authorized the issuance of up to 1,000,000 shares of $0.01 par value preferred stock. The Board of Directors has the authority to issue the preferred stock, in one or more series, and to fix the rights, preferences, privileges and restrictions thereof without any further vote by the holders of Common Stock.

8. Intangible Assets

Intangible assets consist primarily of goodwill and capitalized software. Intangible assets other than goodwill are amortized on a straight-line basis over their estimated useful lives. Prior to 2002, goodwill, representing the excess of the purchase price over the estimated fair value of the net assets of the acquired business, was amortized over the period of expected benefit of five to seven years. However, effective January 1, 2002, the Company adopted Statement of Financial Accounting Standards No. 142, Goodwill and Other Intangible Assets, (SFAS No. 142) which requires that the Company cease amortization of all goodwill and intangible assets having indefinite useful economic lives. The Company determined that there was no impairment upon adoption. Such assets are not to be amortized until their lives are determined to be finite. However, a recognized intangible asset with an indefinite useful life should be tested for impairment annually or on an interim basis if events or circumstances indicate that the fair value of the asset has decreased below its carrying value. At June 30, 2004, the Company evaluated its goodwill and determined that fair value had not decreased below carrying value and no adjustment to impair goodwill was necessary in accordance with SFAS No. 142.

Goodwill and capitalized software as of December 31, 2003 and June 30, 2004 are as follows:

	(dollars in thousands)	
	December 31, 2003	**June 30, 2004**
Goodwill	$ 1,121	$ 1,121
Accumulated amortization		
Goodwill, net	1,121	1,121

Capitalized software		1,755		2,359
Accumulated amortization				
Capitalized software, net		1,755		2,359
Total	$	2,876	$	3,480

Net goodwill is comprised of $665,000 on the purchase of Hotel Information Systems Inc. (HIS) in 1996, $297,000 on the purchase of HSS in 2002 and $159,000 on the purchase of AMDB in 2003 (see Note 4).

The Company s weighted average amortization period for capitalized software is expected to be three years. The Company expects that certain of our new products will be available for general release during the third quarter of 2004 at which time amortization of such costs shall commence. The following table shows the estimated amortization expense for these assets for each of the five succeeding years:

Year Ending December 31, *(in thousands)*	
2004	$ 393
2005	786
2006	786
2007	394
2008	
	$ 2,359

9. Income (Loss) Per Share

Basic and diluted income or loss per share is computed using the weighted average shares of common stock outstanding during the period. Consideration is also given in the diluted income per share calculation for the dilutive effect of stock options and warrants.

The following table illustrates the computation of basic and diluted earnings per share under the provisions of SFAS 128:

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2003	2004	2003	2004
	(in thousands except per share data)		(in thousands except per share data)	
Numerator:				
Numerator for basic and diluted earnings (loss) per share net income (loss)	$ (82)	$ 82	$ 179	$ 248
Denominator:				
Denominator for basic income (loss) per share weighted average number of Common shares outstanding during the period	14,426	14,676	14,426	14,676
Incremental common shares attributable to exercise of outstanding shares			300	
Denominator for diluted income (loss) per per share	14, 426	14,676	14,726	14,676
Basic earnings (loss) per share	$ (0.01)	$ 0.01	$ 0.01	$ 0.02
Diluted earnings (loss) per share	$ (0.01)	$ 0.01	$ 0.01	$ 0.02

The number of anti-dilutive options and warrants that were excluded from the computation of incremental common shares were 3,508,605 and 3,104,000 for the six month period ended June 30, 2003 and 2004, respectively.

10. Stock Option Plans

The Company accounts for stock-based compensation in accordance with Accounting Principles Board, APB, No. 25, Accounting for Stock Issued to Employees. The Company has adopted the disclosure-only provisions of FAS No. 123 Accounting for Stock-Based Compensation. Under APB No. 25, compensation expense relating to employee

stock options is determined based on the excess of the market price of the Company s stock over the exercise price on the date of grant, the intrinsic value method, versus the fair value method as provided under FAS No. 123.

In December 2002, the FASB issued FAS No. 148, Accounting for Stock-Based Compensation Transition and Disclosure , which amended FAS No. 123, Accounting for Stock-Based Compensation. The new standard provides alternative methods of transition for a voluntary change to the fair market value based method for accounting for stock-based employee compensation. Additionally, the statement amends the disclosure requirements of FAS No. 123 to require prominent disclosures in both annual and interim financial statements about the method of accounting for stock-based employee compensation and the effect of the method used on reported results. This statement is effective for financial statements for the year ended December 31, 2002. In compliance with FAS No. 148, the Company has elected to continue to follow the intrinsic value method in accounting for its stock-based employee compensation plan as defined by APB No. 25.

At June 30, 2004, the Company had two stock-based employee compensation plans. The Company accounts for that plan under the recognition and measurement principles of APB No. 25, Accounting for Stock Issued to Employees, and related interpretations. Accordingly, no stock-based employee compensation cost is reflected in net income (loss), as all options granted under the plan had an exercise price equal to the market value of the underlying common stock on the date of grant. Had compensation cost for the Company s stock option plan been determined based on the fair value at the grant date for awards for the three-month periods ended June 30, 2003 and 2004, consistent with the provisions of FAS No. 123, the Company s net income (loss) and net income (loss) per share would have decreased. The following table represents the effect on net income and net income per share if the Company had applied the fair value based method and recognition provisions of Statement of Financial Accounting Standards (SFAS) No. 123, Accounting for Stock-Based Compensation , to stock-based employee compensation.

	For the three-months ended June 30,		For the six-months ended June 30,	
	2003	2004	2003	2004
	(in thousands, except per share data)		(in thousands, except per share data)	
Net income (loss):				
As reported	$ (82)	$ 82	$ 179	$ 248
Add: Stock-based employee compensation expense recorded	10	10	20	20
Less: Stock based employee compensation expense determined under fair value calculations	(33)	(10)	(66)	(20)
Pro forma	$ (105)	$ 82	$ 133	$ 248
Basic income (loss) per share:				
As reported	$ (0.01)	$ 0.01	$ 0.01	$ 0.02
Add: Stock-based employee compensation expense recorded				
Less: Stock based employee compensation expense determined under fair value calculations				
Pro forma	$ (0.01)	$ 0.01	$ 0.01	$ 0.02
Diluted income (loss) per share:				
As reported	$ (0.01)	$ 0.01	$ 0.01	$ 0.02
Add: Stock-based employee compensation expense recorded				
Less: Stock based employee compensation expense determined under fair value calculations				
Pro forma	$ (0.01)	$ 0.01	$ 0.01	$ 0.02

11. Legal Proceedings

Hotel Information Systems, Inc.

On March 25, 2003, the Company entered into a settlement agreement with Hotel Information Systems (HIS) and one of its former corporate officers whereby (i) the parties dismissed all claims, known and unknown, against each other; (ii) the Company forgave and wrote off a note receivable from the former corporate officer of HIS in the amount of $66,000 (which was expensed to other expense in the 2002 consolidated statement of operations); (iii) the Company paid $50,000

in cash and issued a non-interest bearing unsecured promissory note which requires 35 consecutive monthly payments of $5,000 each commencing April 1, 2003; and (iv) the remaining 374,116 shares in the escrow account will be released to the Company. If the Company is delinquent four times in any twelve-month period during the term of the unsecured promissory note in making its $5,000 monthly payments to HIS, and HIS issues respective valid default notices, the Company will be subject to a $225,000 penalty. The 374,116 shares have been received by MAI together with the HIS authorization to legally transfer such shares to MAI.

Imputing interest at 11%, the present value of the $175,000 promissory note at the date of the settlement was $149,000. The Company recorded the present value of this debt issuance and the $50,000 cash payment as a reduction to additional paid-in capital.

Logix Development Corporation

The Company entered into a settlement agreement with Logix Development Corporation (Logix) in July of 2002 whereby we (i) issued Logix 200,000 shares of our Common Stock (ii) required the Company to make various cash installment payments totaling $175,000 to be paid within 1 year and (iii) executed a contract with Logix for a consulting project in the amount of $50,000. The Company has made all required payments to Logix under this settlement agreement.

In December 2003, the Company entered into another settlement agreement with Logix whereby it (i) issued 200,000 free trading shares in exchange for the 200,000 restricted Common Shares from the original settlement agreement in July 2002 (ii) required the Company to make monthly payments totaling $187,500 over a 25 month period and (iii) mutually released each other of all past, present and future claims associated with the lawsuit.

Other Litigation

We were also involved in various other legal proceedings that are incident to its business. Management believes the ultimate outcome of these matters will not have a material adverse effect on our consolidated financial position, results of operations or liquidity.

12. Comprehensive Income

The following table summarizes components of comprehensive income:

	For The Three Months Ended June 30,		For The Six Months Ended June 30,	
	2003	**2004**	**2003**	**2004**

Net income (loss)	$ (82)	$ 82	$ 179	$ 248
Change in cumulative translation adjustments	40	(37)	40	(57)
Comprehensive income (loss)	$ (42)	$ 45	$ 219	$ 191

Accumulated other comprehensive income in the accompanying consolidated balance sheets consists of cumulative translation adjustments.

Item 2. Management s Discussion And Analysis Of Financial Condition And Results Of Operations

Critical Accounting Policies and Estimates

The discussion and analysis of our financial condition and results of operations are based upon our condensed 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 our reported assets, liabilities, revenues and expenses. On an on-going basis, we evaluate our estimates, including those related to revenue recognition, accounts receivable and intangible assets. We base our estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances. This forms the basis of judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions.

We believe the following critical accounting policies and the related judgments and estimates affect the preparation of our consolidated financial statements:

Revenue Recognition

The Company earns revenue from sales of hardware, software and professional services and from arrangements involving multiple elements of each of the above. Revenue for multiple element arrangements are recorded by allocating revenue to the various elements based on their respective fair values as evidenced by vendor specific objective evidence. The fair value in multi-element arrangements is determined based upon the price charged when sold separately. Revenue is not recognized until persuasive evidence of an arrangement exists, delivery has occurred, the fee is fixed or determinable and collectibility is probable. Sales of network and computer equipment are recorded when title and risk of loss transfers. Software revenues are recorded when application software programs are shipped to end users, resellers and distributors, provided the Company is not required to provide services essential to the functionality of the software or significantly modify, customize or produce the software. Professional services fees for software development, training and installation are recognized as the services are provided. Maintenance revenues are recorded evenly over the related contract period.

Accounts Receivable

We maintain allowances for doubtful accounts for estimated losses resulting from the inability of our customers to make required payments. The amount of our reserves is based on historical experience and our analysis of the accounts receivable balances outstanding. If the financial condition of our customers were to deteriorate, resulting in an impairment of their ability to make payments, additional allowances may be required which would result in an additional general and administrative expense in the period such determination was made. While such credit losses have historically been within our expectations and the provisions established, we cannot guarantee that we will continue to experience the same credit loss rates that we have in the past.

Intangible and Long-Lived Assets

At December 31, 2003 and June 30, 2004, goodwill and other long-lived assets represented 44% and 45%, respectively, of the Company s total assets.

Goodwill must be tested at least annually for impairment at a level of reporting referred to as the reporting unit and more frequently if adverse events or changes in circumstances indicate that the asset may be impaired. The Company did not record an impairment charge upon completion of the initial impairment reviews on January 1, 2002 or upon its annual impairment review at December 31, 2003.

Long-lived assets consist of property and equipment and other identifiable intangible assets. These assets are depreciated or amortized over their estimated useful life, and are subject to impairment reviews. The Company periodically reviews long-lived assets whenever adverse events or changes in circumstances indicate the carrying value of such assets may not be recoverable. In assessing recoverability, the Company must make assumptions regarding estimated future cash flows and other factors to determine if an impairment loss may exist, and, if so, estimate fair value. The Company also must estimate and make assumptions regarding the useful lives assigned to its long-lived assets. If these estimates, or

their related assumptions, change in the future, the Company may be required to record impairment losses or change the useful life including accelerating depreciation or amortization for these assets.

Accrued Expenses

The Company reviews its contingent liabilities, which arise primarily from litigation and litigation defense costs, in accordance with Statement of Financial Accounting Standards No. 5 (SFAS 5), Accounting for Contingencies . Contingent liabilities are recorded as liabilities when it is probable that a liability has been incurred and the amount of the loss is reasonably estimable. Contingent liabilities are often resolved over long periods. Estimating probable losses requires judgments about both the amount of liability, which may or may not be readily determinable, and the likelihood of liability, which involves ranges of probability that can at times be broad and depend on the potential actions of third parties.

Provision for Income Taxes

Provision for income taxes is based upon the Company s estimate of taxable income or loss for each respective accounting period. An asset or liability is recognized for the deferred tax consequences of temporary differences between the tax bases of assets and liabilities and their reported amounts in the financial statements. These temporary differences will result in taxable or deductible amounts in future periods when the reported amounts of assets are recovered or liabilities are settled. The Company regularly reviews its deferred tax assets to determine the amount that is more likely than not to be realized. When this amount is less than the deferred tax asset recorded, the Company records a valuation allowance to reduce the asset to its estimated realizable value. If the Company determined that it was not going to be able to fully realize its recorded deferred tax assets, it would make an adjustment to the valuation allowance. This would reduce net income in the period that the Company made its determination. Similarly, if the Company realized that it was going to be able to fully realize a deferred tax asset in excess of its net recorded value, net income would be increased in the period that the Company made its determination.

The Company also reviews its deferred tax liabilities on a regular basis to determine that the amount recorded is adequate to cover the expected reversal of temporary income tax liabilities. In the event that the amount recorded was less than adequate, the deferred tax liability would be increased to its estimated realizable value and net income would be decreased accordingly. In the event that the deferred tax liability was determined to be overstated, it would be reduced to its estimated realizable value and net income would increase accordingly.

The Company generally determines its effective tax rate by considering the statutory federal income tax rate, the statutory state and local tax rates (net of the federal income tax benefit) and any nondeductible expenses. This rate could also be affected by increases or decreases to deferred tax assets or liabilities as described above.

Software Development Costs

All costs incurred to establish the technological feasibility of software products to be sold to others are expensed as research and development. Once technological feasibility has been established, all software production costs are capitalized. Amortization is computed on an individual product basis and is recognized over the greater of the remaining economic lives of each product or the ratio that current gross revenues for a product bear to the total of current and anticipated revenues for that product, commencing when the products become available for general release to customers. Software development costs are generally amortized over a three-year period. The Company continually assesses the recoverability of software development costs by comparing the carrying value of individual products to their net realizable value.

The Company capitalized $419,000 and $604,000 of software development costs for the period ending June 30, 2003 and 2004 respectively, relating to our new N-Tier, Internet-native corporate application suite of products written in java. Although we have not yet sold any of the modules to this suite of applications, we believe that these new products will produce new sales adequate to recover amounts capitalized. We expect that certain of our new products will be available for general release during the third quarter of 2004 at which time amortization of such costs shall commence.

Liquidity and Capital Resources

At June 30, 2004, our working capital deficiency decreased from a working capital deficiency of $10,399,000 at December 31, 2003 to a working capital deficiency of $7,854,000. Excluding unearned revenue of $4,787,000, working capital deficiency at June 30, 2004 was $3,067,000. Excluding unearned revenue of $3,209,000, the Company s working capital deficiency at December 31, 2003 was $7,190,000. Excluding unearned revenue, the decrease in the working capital deficiency of $4,123,000 was primarily attributable to increases in receivables of $696,000, and decreases in current portion of long term debt of $2,732,000, customer deposits of $871,000, accrued liabilities of $637,000 offset by decrease in cash of $535,000 and increase in accounts payable of $253,000.

Net cash used in investing activities for the period ended June 30, 2004 totaled $714,000, which is comprised of capital expenditures of $110,000 and capitalized software of $604,000.

Net cash used in financing activities for the period ended June 30, 2004 totaled $425,000, which represents repayments on long-term debt. On March 31, 2004, the Company successfully re-negotiated the terms of its Wamco loan whereby the maturity date was extended to February 28, 2006. In addition, various restrictions and covenants, pursuant to the inter-creditor agreement between Canyon and Wamco, were amended to include a minimum quick ratio of 0.20 to 1.00

and a minimum debt coverage ratio of 0.50 to 1.00 which commence as of and for the three month period ended March 31, 2004 and for each and every fiscal quarter ending thereafter. The Company was not in compliance with the amended debt covenants as of and for the period ending June 30, 2004, but obtained a waiver for non-compliance. There is no guaranty that the Company will meet its debt covenants in the future. In the event that the Company were not in compliance with the various restrictions and covenants and were unable to receive waivers for non-compliance, the term loan would be immediately due and payable.

Stockholders deficiency decreased from $14,586,000 at December 31, 2003 to $14,377,000 at June 30, 2004, mainly as a result of net income during the period of $248,000.

Although the Company has a net stockholders deficiency of $14,377,000 and a working capital deficit of $7,854,000 at June 30, 2004, the Company believes it will generate sufficient funds from operations and through its proposed private placement of $1 million from an Investor Group to meet its operating and capital requirements. In the event that the Company cannot generate positive cash flow from its operations during 2004, the Company can substantially reduce its research and development efforts to mitigate cash outflow to help sustain its operations. There can be no assurance that the Company will be able to sustain profitability or generate positive cash flow from operations; however, the Company expects to generate positive cash flow from its operations during 2004 from shipping out products and services from its current backlog as of June 30, 2004 as well as new orders and a private placement of $1 million from an Investor Group. These financial statements have been prepared assuming the Company will continue to operate as a going concern. If the Company is unsuccessful in the aforementioned efforts, the Company could be forced to liquidate certain of its assets, reorganize its capital structure and, if necessary, seek other remedies available to the Company, including protection under the bankruptcy laws.

Contractual Obligations and Commercial Commitments

The following table summarizes the Company s obligations and commitments as of June 30, 2004, excluding interest:

	Payments Due by Period (in thousands)				
Contractual Cash Obligations	**Total**	**Less Than 1 Year**	**1-3 Years**	**4-5 Years**	**After 5 Years**
Long-Term Debt	$ 11,200	$ 914	$ 8,123	$ 1,774	$ 389
Operating Leases	1,621	514	927	127	53
Consulting Agreements	60	60			
	$ 12,881	$ 1,488	$ 9,050	$ 1,901	$ 442

Results of Operations

Three Months Ended June 30, 2003 Compared to Three Months Ended June 30, 2004

	June 30, 2003 (in thousands)	Percentage of Revenue	June 30, 2004 (in thousands)	Percentage of Revenue
Revenue:	$ 4,752	100.0%	$ 4,901	100.0%
Gross profit	3,526	74.2%	3,671	74.9%
Selling, general and administrative expenses	2,438	51.3%	2,351	48.0%
Research and development costs	658	13.9%	908	18.5%
Other operating expense	3	0.1%	15	0.3%
Interest expense, net	292	6.2%	288	5.9%
Other non-operating expense	212	4.5%	23	0.5%
Income tax expense	5	0.1%	4	0.1%
Net income (loss)	$ (82)	(1.7)%	$ 82	1.7%

Revenue for 2004 was $4,901,000 compared to $4,752,000 in 2003 or a 3.1% increase. Revenue increased $149,000 in 2004, as a result of increased software maintenance service.

Gross profit for 2004 increased to $3,671,000 from $3,526,000 in 2003. The increase in gross profit is mainly due to the increase in professional and maintenance services revenues from 2003 to 2004.

Selling, general and administrative expenses (SG&A) decreased from $2,438,000 in 2003 to $2,351,000 in 2004. The decrease is mainly due to the management cost control program by reducing vendor costs and consulting services.

Research and development costs increased from $658,000 in 2003 to $908,000 in 2004. The increase is mainly due to new hires, it s related cost and consulting services. The Company capitalized $190,000 and $282,000 of software development costs in 2003 and 2004, respectively, associated with the Company s product development of its new internet native suite of applications as well as our core product offerings.

Net interest expense was $292,000 in 2003 compared to $288,000 in 2004. The decrease is due to lower balances of interest bearing debt during 2004 as compared to 2003.

Other non-operating expense increased from $212,000 in 2003 to $23,000 in 2004. In 2003 non-operating expense relates to pension expense under a defined benefit plan for former employees from our discontinued operations. Other non-operating expense of $23,000 in 2004 relates to minority interest expenses associated with our Asian Operations. There were no such expense recorded in 2003.

The income tax benefit in 2003 is due to the Company recording a domestic income tax receivable during the period to recover taxes previously paid. There were no such receivables recorded in 2004.

Six Months Ended June 30, 2003 Compared to Six Months Ended June 30, 2004

	June 30, 2003 (in thousands)	Percentage of Revenue	June 30, 2004 (in thousands)	Percentage of Revenue
Revenue	$ 9,938	100.0%	$ 10,074	100.0%
Gross profit	7,241	72.9%	7,394	73.4%
Selling, general and administrative expenses	4,969	50.0%	4,700	46.7%
Research and development costs	1,340	13.5%	1,800	17.9%
Other operating expense (income)	(46)	(0.5)%	18	0.2%
Interest expense, net	641	6.4%	579	5.8%
Other non-operating expense	212	2.1%	39	0.4%
Income tax expense (benefit)	(54)	(0.5)%	10	0.1%
Net income	$ 179	1.8%	$ 248	2.5%

Revenue for 2004 was $10,074,000 compared to $9,938,000 in 2003 or a 1.4% increase. Revenue increased $136,000 in 2004, as a result of increased professional services revenue as well as maintenance service price increases.

Gross profit for 2004 increased to $7,394,000 from $7,241,000 in 2003. The increase in gross profit is mainly due to the increase in professional and maintenance services revenues.

Selling, general and administrative expenses (SG&A) increased from $4,969,000 in 2003 to $4,700,000 in 2004. The decrease is mainly due to a decrease in headcount associated with the Company s focus on reducing costs, such as building rent and consulting services.

Research and development costs increased from $1,340,000 in 2003 to $1,800,000 in 2004. The company capitalized $419,000 and $604,000 of software development costs in 2003 and 2004, respectively. The increase is mainly due to the Company continued efforts to invest in product development of its new internet native suite of applications as well as our core product offerings.

Other operating expense (income) was ($46,000) in 2003 and $18,000 in 2004. Other operating income in 2003 is due to receipt of approximately $46,000 of cash resulting from a legal settlement.

Net interest expense was $641,000 in 2003 compared to $579,000 in 2004. The decrease is due to lower balances of interest bearing debt during 2004 as compared to 2003.

Other non-operating expense increased from $212,000 in 2003 to $39,000 in 2004. In 2003 non-operating expense relates to pension expense under a defined benefit plan for former employees from our discontinued operations. Of other non-operating expense of $39,000 in 2004,

$22,000 relates to minority interest expense associated with our Asia Operations. There were no such expense recorded in 2003.

The income tax benefit in 2003 is due to the Company recording a domestic income tax receivable during the period to recover taxes previously paid. There were no such receivables recorded in 2004.

Item 3. Quantitative And Qualitative Disclosures About Market Risk

Market Risk Disclosures

The following discussion about our market risk disclosures contains forward-looking statements. Forward-looking statements are subject to risks and uncertainties. Actual results could differ materially from those discussed in the forward-looking statements. We are exposed to market risk related to changes in interest rates and foreign currency exchange rates. We do not have derivative financial instruments for hedging, speculative, or trading purposes.

Interest Rate Sensitivity

Of our $11.2 million principal amount of indebtedness at June 30, 2004, none bears interest at a variable rate. However, $5.7 million bears interest at a fixed rate of 11%, $3.6 million bears interest at a fixed rate of 10%, $1.0 million bears interest at 9.25% and $0.9 million bears fixed interest rates ranging from 6% to 17.5%. Since these debt instruments bear interest at fixed rates, we have no exposure to decreases in interest rates because we still are required to pay the fixed rate even if current interest rates are lower.

Foreign Currency Risk

We believe that our exposure to currency exchange fluctuation risk is reduced because our transactions with international vendors and customers are generally transacted in US dollars. The currency exchange impact on intercompany transactions was immaterial for the quarter ended June 30, 2004.

Item 4. Evaluation of Disclosure Controls and Procedures

(a) Evaluation of disclosure controls and procedures

We evaluated the design and operation of our disclosure controls and procedures to determine whether they are effective in ensuring that we disclose the required information in a timely manner and in accordance with the Securities Exchange Act of 1934, as amended, or the Exchange Act, and the rules and forms of the Securities and Exchange Commission. Management, including our principal executive officer and principal financial officer, supervised and participated in the evaluation. The evaluation was completed as of June 30, 2004. The principal executive officer and principal financial officer concluded, based on their review, that our disclosure controls and procedures, as defined by Exchange Act Rules 13a-14(c) and 15d-14(c), are effective and ensure that we disclose the required information in reports that we file under the Exchange Act and that the filings are recorded, processed, summarized and reported within the time periods specified in Securities and Exchange Commission rules and forms. No significant changes were made to our internal controls or other factors that could significantly affect these controls subsequent to the date of their evaluation.

A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Because of the inherent limitations in all control systems no evaluation of controls can provide absolute assurance that all control issues if any, within a company have been detected.

On August 20, 2004, the Company s independent auditors orally notified the Company s Audit Committee that they had identified significant deficiencies regarding the Company s internal controls. The deficiencies noted were (a) the lack of segregation of duties, (b) the lack of adequate account analysis and reconciliations, and (c) insufficient supervision of the Company s accounting personnel. The Company believes such deficiencies were primarily attributable to changes in personnel within the accounting department combined with a lack of adequate resources.

Based on the investigation by the Company s Audit Committee and additional procedures performed by management, the Company has concluded that, except as noted above, and subject to the inherent limitations in all control systems, the Company s current disclosure controls and procedures are sufficient to timely alert the Company s management to material information relating to the Company that is required to be included in our periodic Securities and Exchange Committee filings, and that the internal controls are sufficient to provide reasonable assurance that the consolidated financial statements are fairly presented in conformity with generally accepted accounting principles.

(b) Changes in internal controls

There were no significant changes in our internal controls or to our knowledge, in other factors that could significantly affect our disclosure controls and procedures subsequent to the Evaluation Date.

PART II - OTHER INFORMATION

Item 1. Legal Proceedings

Hotel Information Systems, Inc.

On March 25, 2003, the Company entered into a settlement agreement with Hotel Information Systems (HIS) and one of its former corporate officers whereby (i) the parties dismissed all claims, known and unknown, against each other; (ii) the Company forgave and wrote off a note receivable from the former corporate officer of HIS in the amount of $66,000 (which was expensed to other expense in the 2002 consolidated statement of operations); (iii) the Company paid $50,000 in cash and issued a non-interest bearing unsecured promissory note which requires 35 consecutive monthly payments of

$5,000 each commencing April 1, 2003; and (iv) the remaining 374,116 shares in the escrow account will be released to the Company. If the Company is delinquent four times in any twelve-month period during the term of the unsecured promissory note in making its $5,000 monthly payments to HIS, and HIS issues respective valid default notices, the Company will be subject to a $225,000 penalty. The 374,116 shares have been received by MAI together with the HIS authorization to legally transfer such shares to MAI.

Imputing interest at 11%, the present value of the $175,000 promissory note at the date of the settlement was $149,000. The Company recorded the present value of this debt issuance and the $50,000 cash payment as a reduction to additional paid-in capital.

Logix Development Corporation

The Company entered into a settlement agreement with Logix Development Corporation (Logix) in July of 2002 whereby we (i) issued Logix 200,000 shares of our Common Stock (ii) required the Company to make various cash installment payments totaling $175,000 to be paid within 1 year and (iii) executed a contract with Logix for a consulting project in the amount of $50,000. The Company has made all required payments to Logix under this settlement agreement.

In December 2003, the Company entered into another settlement agreement with Logix whereby it (i) issued 200,000 free trading shares in exchange for the 200,000 restricted Common Shares from the original settlement agreement in July 2002 (ii) required the Company to make monthly payments totaling $187,500 over a 25 month period and (iii) mutually released each other of all past, present and future claims associated with the lawsuit.

Other Litigation

The Company is also involved in various other legal proceedings and claims that are incidental to its business. Management believes the ultimate outcome of these matters will not have a material adverse effect on the consolidated financial position, results of operations or liquidity of the Company.

Item 2. Changes in Securities and Use of Proceeds

(a) None.

(b) None.

(c) None

(d) None.

Item 3. Defaults Upon Senior Securities

(a) None

Item 4. Submission of Matters to a Vote of Security Holders

(a) None

(b) None

(c) None

(d) None

Item 5. Other Information

(a) None.

Item 6. Exhibits and Reports on Form 8-K

(a) Exhibits

31.1 Certification of Chief Executive Officer, W. Brian Kretzmer, as required by Section 3.02 of Sarbane-Oxley Act of 2002

31.2 Certification of Chief Financial Officer, James W. Dolan, as required by Section 3.02 of Sarbane-Oxley Act of 2002

32.1 Certification of Chief Executive Officer, W. Brian Kretzmer, as required by Section 9.06 of Sarbane-Oxley Act of 2002

32.2 Certification of Chief Financial Officer, James W. Dolan, as required by Section 9.06 of Sarbane-Oxley Act of 2002

(b) Reports on Form 8-K

Filed April 1, 2004

Filed April 12, 2004

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.

MAI SYSTEMS CORPORATION
(Registrant)

Date: August 23, 2004

By: /s/James W. Dolan
James W. Dolan
Chief Financial and Operating Officer
(Chief Financial and Accounting Officer)